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THE LAW AND ECONOMICS OF DIVIDEND POLICY

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IN a recent article, Professor Victor Brudney of Harvard University, a prominent scholar of corporate law, has attempted a reevaluation of the legal rules and assumptions concerning dividend policy.[1] Relying on economic as well as legal literature, professor Brudney reached the following conclusions:

> . Dividend policy is likely to have an effect on share prices independent of earnings;[2]
>
> . Because of various conflicts of interest, management is likely to pursue a systematically suboptimal dividend policy to the detriment of shareholders;[3] and
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> . Mandatory disclosure of the reasons for the dividend decision will, in certain circumstances, benefit shareholders by clarifying the otherwise ambiguous dividend message and by minimizing the conflict of interest between managers and shareholders.[4]

Professor Brudney's view of the dividend decision process is one in which helpless shareholders are at the mercy of self-interested management. Despite the shareholders' preference for current income in the form of dividends, management, Brudney argues, will, because of its conflict of interest, systematically retain earnings to the detriment of shareholders.[5] Moreover, shareholders are further prejudiced, the argument runs, by their inability to understand the inherently ambiguous message of the dividend decision.[6] Brudney concludes that mandatory disclosure by management of the basis for its dividend decision will, in certain circumstances, make stock prices more "correct" by dispelling any ambiguity in the underly-

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* Assistant Professor of Law, Northwestern University. I would like to thank Walter J. Blum, Peter Dodd, Michael P. Dooley, Frank H. Easterbrook, Merton H. Miller, and the participants of the faculty workshop at Northwestern University for their helpful comments on an earlier draft of this article.

[1] Brudney, *Dividends, Discretion, and Disclosure,* 66 VA. L. REV. 85 (1980).

[2] *See id.* at 97.

[3] *See id.* at 107.

[4] *See id.* at 121, 125.

[5] *See id.* at 95.

[6] *See id.* at 109-14.

ing message and will act as a check on self-interested management behavior.[7]

Professor Brudney's attempt to rethink dividend policy (one of the most poorly understood areas of corporate finance)[8] is ambitious and his research is thorough. But his neglect of much of the relevant financial and empirical evidence, his failure to recognize adequately the market forces that provide management with incentives to set dividend policy in the best interests of shareholders, and his exaggeration of the benefits of disclosure and lack of regard for its costs undermine both his analysis and his conclusions. My purpose here is to illustrate these points and, more generally, to demonstrate that current legal rules giving management virtually unlimited discretion in making the dividend decision maximize shareholder welfare.[9]

I. Dividend Policy and Share Prices

One of the critical assumptions of Professor Brudney's thesis is that because of shareholder preference for current income in the form of dividends, dividend policy has an effect on share prices independent of earnings.[10] This assumption is critical because if dividend policy did not have an independent impact on share prices, there would be no need to be concerned with any management bias in favor of retention. Dividend policy would simply be irrelevant and management could make investment decisions without regard to dividend policy.[11] Despite the importance of this assumption, however, Professor Brudney is unable to advance any

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[7] *See id.* at 129.

[8] There are as yet no definitive answers to such basic questions as why corporations pay dividends, why they typically maintain a consistent payout policy, what impact dividend policy has on share prices, and to what extent dividends convey information to investors about future prospects. *See generally* Black, *The Dividend Puzzle,* 2 J. Portfolio Management 5 (Winter 1976). Although there is considerable empirical evidence on many of these issues, *see* notes 12-57 *infra* and accompanying text, the debate rages on. For a comprehensive and illuminating discussion of the current state of the literature, see T. Copeland & J. Weston, Financial Theory and Corporate Policy 327-71 (1979).

[9] My analysis is confined to dividend policy in the large, publicly held corporation. Dividend policy in the close corporation presents entirely different questions. *See* Manne, *Our Two Corporation Systems: Law and Economics,* 53 Va. L. Rev. 259, 280-81 (1967).

[10] *See* Brudney, *supra* note 1, at 88.

[11] This assertion is something of an overstatement because management would still be concerned with such factors as the tax consequences of the dividend decision and flotation costs. *See* notes 29-36 *infra* and accompanying text.

convincing theoretical or empirical support for it. In fact, the overwhelming weight of theoretical authority and recent empirical evidence does not support the proposition that dividend policy affects share prices apart from earnings.

A. The Irrelevance Proposition

In their seminal article, Miller and Modigliani[12] demonstrated that once a firm's investment policy is known, its dividend policy will affect neither the current price of its shares nor the total return to its shareholders. This conclusion merely illustrates the more general principle that "there are no 'financial illusions' in a rational and perfect economic environment."[13] Share values in such an environment are "determined solely by 'real' [economic] considerations—. . . the earning power of the firm's assets and its investment policy."[14] Because a firm's dividend policy (once the investment policy is known) is simply a decision as to how the firm's real value sould be packaged for distribution, it should have no effect on share prices.[15]

The "irrelevance" of dividend policy can be illustrated from the perspective of either the firm or its shareholders. Leaving market imperfections aside for the moment,[16] assume that a firm has a favorable investment opportunity requiring $100 of capital. It can either forgo a dividend and finance this investment opportunity with retained earnings, or it can pay a dividend and finance the investment opportunity externally by selling new equity.[17] The firm can take advantage of the investment opportunity in either

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[12] Miller & Modigliani, *Dividend Policy, Growth and the Valuation of Shares,* 34 J. Bus. 411 (1961).

[13] *Id.* at 414. Perhaps the simplest proof of the proposition that a firm's dividend policy does not affect the firm's value is that if a firm's value could be lowered by its dividend policy (or other factors such as capital structure unrelated to future earnings considerations), it would be possible to purchase a firm and make an arbitrage profit simply by switching to the optimal dividend policy. Because such profits are inconsistent with equilibrium, the firm's value must be constant regardless of dividend policy. *See* Ross, *The Determination of Financial Structure: The Incentive-Signalling Approach,* 8 Bell J. Econ. & Management Sci. 23 (1977).

[14] Miller & Modigliani, *supra* note 12, at 414.

[15] *See id. See also* J. Lorie & M. Hamilton, The Stock Market: Theories and Evidence 119 (1973).

[16] *See* notes 29-36 *infra* and accompanying text.

[17] External financing could also take the form of borrowing.

case.[18]

Once investment policy is known, the shareholder is also indifferent as to retention of earnings or payment of a dividend. If a dividend is declared and funds are needed for favorable investments, new stock must be sold to acquire the necessary capital. Although income from the dividend benefits the shareholder, his proportionate ownership of the firm is reduced. The value of the dividend is exactly offset by the decline in value of existing shares caused by the sale of new equity.[19] Thus, if the total value of the dividend is $100, the firm must sell new shares worth $100, thereby reducing the value of existing shares by that amount. The shareholder's position is neither better nor worse than before declaration of the dividend.[20]

Moreover, dividend policy does not affect a shareholder's ability to recognize current income. If a firm retains earnings rather than paying a dividend, the price of the firm's shares will rise accordingly. A shareholder who wants current income can simply sell part of his holdings. Conversely, a shareholder who does not want current income can simply invest any dividends paid by purchasing new shares. From the perspective of either the firm or the shareholder, therefore, dividends are irrelevant.

B. The "Bird in the Hand" Fallacy

The irrelevance proposition assumes that once a firm's investment policy is known, shareholders are indifferent as to a dividend

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[18] More generally, the firm can choose any dividend policy without affecting the stream of cash flow from the firm's assets. It could, for example, pay dividends in excess of cash flow and still not forsake any favorable investments. The needed extra funds could be obtained through external financing such as the selling of new equity. Conversely, the firm could pay dividends less than the amount left over from operations after making investments. The extra cash then could be used to repurchase shares. From the perspective of the firm, therefore, dividend policy is simply irrelevant.

[19] An increase in current dividends, given a firm's investment policy, must necessarily reduce the value of existing shares because part of the future dividend stream that would otherwise have accrued to the existing shares had there been no increase in current dividends will now be diverted to new shareholders or bondholders. This reduction in the terminal value of the shares of existing stockholders, however, is exactly offset by the value of the current dividend. *See* Miller & Modigliani, *supra* note 12, at 420.

[20] The reasoning is symmetrical if dividends are reduced. The reduction in value of the cash receipt is exactly offset by the increase in value per share caused by the reduction in the number of outstanding shares that results if the excess cash is used to buy its shares in the open market. *See* J. LORIE & M. HAMILTON, *supra* note 15, at 120.

payout or retention. Brudney, however, suggests that stockholders may rationally prefer a current dividend to the capitalized value of future payments.[21] Because most shareholders are risk averse, the argument runs, they prefer a dollar in dividends to a dollar retained by the firm because, "as expected earnings become more remote, the present value of capitalizing those earnings cannot equal the cash value of the dividend in hand."[22] Under this assumption, dividend policy could affect share prices apart from earnings.

As has been repeatedly demonstrated elsewhere, the "bird in the hand" attack on the irrelevance proposition is erroneous.[23] The risk of a firm is determined by the variability of the cash flow from its investments.[24] Lorie and Hamilton have observed that

> [i]n order for the dollar paid in dividends to be less risky and valued more highly than the dollar retained by the corporation, it would be necessary to assume that investment by the dividend recipient would be less risky than internal investment by the firm. . . . There is no *a priori* reason to believe in the existence of that superiority or in the irrationality of the firm, and therefore there is no reason to believe that earnings paid out will be valued more highly than earnings retained.[25]

A dividend payment does not affect risk; rather, it reduces the proportion of the investor's assets in equities. The investor who believes the firm's investment policy is too risky would desire such a reduction. If the investor wishes to reduce his investment in a firm, however, he can do so by selling part of his holdings.[26] For shareholders who prefer a "bird in the hand" to the perceived uncertainties of corporate investment, such "homemade dividends"

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[21] *See* Brudney, *supra* note 1, at 88, 95-96. The "bird in the hand" argument has previously been advanced in several older studies. *See, e.g.*, Gordon, *Dividends, Earnings and Stock Prices*, 41 REV. ECON. & STATISTICS 99 (1959); Lintner, *Optimal Dividends and Corporate Growth Under Uncertainty*, 78 Q.J. ECON. 68 (1964).

[22] *See* Brudney, *supra* note 1, at 88.

[23] *See, e.g.*, R. BREALEY, SECURITY PRICES IN A COMPETITIVE MARKET 6 (1971); T. COPELAND & J. WESTON, *supra* note 8, at 337; J. LORIE & M. HAMILTON, *supra* note 15, at 121; Brennan, *A Note on Dividend Irrelevance and the Gordon Valuation Model*, 26 J. FINANCE 1115, 1119 (1971).

[24] T. COPELAND & J. WESTON, *supra* note 8, at 337.

[25] J. LORIE & M. HAMILTON, *supra* note 15, at 121.

[26] Indeed, an invester who believes that his own investment choices are less risky than the firm's might well decide to sell all his holdings in that firm.

substitute perfectly for corporate dividends. Because the firm's issuance of a dividend does not give shareholders anything they cannot provide for themselves, the firm's dividend decision cannot affect share prices if shareholders are acting rationally.[27] In sum, a current increase in dividend payout will not increase the value of the firm by reducing the riskiness of future investments, but rather will lower the postdividend price of the stock.[28]

C. *The Effect of Market Imperfections: The Clientele Effect*

The irrelevance proposition assumes away many market imperfections such as taxes, flotation costs, transaction costs, and constraints on the securities that can be owned by institutional investors. Consideration of these factors, however, does not support the conclusion that investors prefer dividend payout over retention. Indeed, Professor Brudney himself states that "the weight of the frictions and imperfections that exist in the market . . . should lead to shareholder preference for lower payouts."[29]

A brief examination of the significant market imperfections demonstrates that these imperfections, on balance, do not lead investors to prefer dividend payouts.[30] When funds are needed for investment, flotation costs favor the use of retained earnings, thereby discouraging dividend payouts. Transaction costs should not cause shareholders to favor either dividends or retention. Shareholders who want current income when the firm retains earnings must sell part of their shares and thus pay commissions. Conversely, shareholders who want to reinvest a dividend must pay brokerage fees. Thus, in the aggregate, transaction costs will not cause shareholders consistently to prefer either dividends or retention. On the other hand, certain institutional investors are prohibited by law from investing in firms that do not maintain a certain dividend policy, and such restrictions tend to create a slight preference for current income.

Nor do taxes, the most significant market imperfection, support the conclusion that investors prefer dividends. Because dividends

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[27] *See* J. Van Horne, Financial Management and Policy 283 (1977).

[28] *See* T. Copeland & J. Weston, *supra* note 8, at 337.

[29] Brudney, *supra* note 1, at 91.

[30] The effect of these market imperfections is discussed in more detail in J. Van Horne, *supra* note 27, at 286-88.

to individual investors are taxed at a higher rate than capital gains,[31] these investors should arguably prefer retention over payout. On the other hand, corporate investors might well favor payouts because intercompany dividends are taxed at a lower rate than capital gains.[32] Tax-exempt institutional investors should be indifferent as to dividends or capital gains.

The different tax consequences of a dividend payout for various classes of investors has led to the suggestion that corporations with different payout policies would attract their own " 'clientele' consisting of those preferring its particular payout ratio."[33] Several studies have found empirical evidence of a tax-induced clientele effect.[34] Other studies, however, have challenged these findings and have argued that the rational investor, regardless of tax considerations, should not take yield into account in choosing his strategy, but should focus instead on diversifying his portfolio.[35]

It must be emphasized, however, that the clientele effect, even if it exists, does not necessarily demonstrate that dividend policy determines the market price of a firm's stock. A firm could sell at a

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[31] Dividends, except for the first $100, *see* I.R.C. § 116, are fully taxable, *id.* § 61(a)(7), whereas 60% of capital gains is excluded from an individual's taxable income, *see id.* § 1202.

[32] Corporations are allowed a deduction equal to 85% of the dividends received from domestic corporations. *See id.* § 243.

[33] Miller & Modigliani, *supra* note 12, at 431. The clientele effect was first suggested by Miller and Modigliani:

> If, for example, the frequency distribution of corporate payout ratios happened to correspond exactly with the distribution of investor preferences for payout ratios, then the existence of these preferences would clearly lead ultimately to a situation whose implications were different in no fundamental respect from the perfect market case. Each corporation would tend to attract to itself a "clientele" consisting of those preferring its particular payout ratio, but one clientele would be entirely as good as another in terms of the valuation it would imply for the firm.

Id.

[34] *See, e.g.*, Elten & Gruber, *Marginal Stockholder Tax Rates and the Clientele Effect*, 52 Rev. Econ. & Statistics 68 (1970); Litzenberger & Ramaswamy, *Dividends, Short Selling Restrictions, Tax-Induced Investor Clienteles and Market Equilibrium*, 35 J. Finance 469 (1980) [hereinafter cited as *Dividends*]; Litzenberger & Ramaswamy, *The Effect of Personal Taxes and Dividends on Capital Asset Prices: Theory and Empirical Evidence*, 7 J. Financial Econ. 163 (1978) [hereinafter cited as *Personal Taxes*]; Pettit, *Taxes, Transactions Costs and Clientele Effects of Dividends*, J. Financial Econ. 419 (1977). *But cf.* note 35 *infra* and accompanying text (studies questioning clientele effect).

[35] *See* Black & Scholes, *The Effects of Dividend Yield and Dividend Policy on Common Stock Prices and Returns*, 1 J. Financial Econ. 1 (1974). *See also* M. Miller & M. Scholes, Dividends and Taxes: Some Empirical Evidence (Nov. 11, 1980) (unpublished manuscript) (copy on file with the Virginia Law Review Association).

premium because of its dividend policy only if the market were unresponsive to investor preferences and, thus, investors generally were receiving smaller or larger dividends than they required.[36] Because such a state of disequilibrium could exist, if at all, only in the short run, there is little possibility that a particular dividend policy will cause a security to sell at a premium.

D. Dividends and Stock Prices: The Empirical Evidence

Rather than demonstrating any flaws in the irrelevance propositon, Brudney relies primarily on empirical evidence to support the proposition that dividend policy affects share prices apart from earnings.[37] Thus, Brudney states that available evidence suggests that investors "prefer high payout to low payout stocks, even if payment of dividends is less wealth-enhancing than retention and reinvestment of earnings."[38] He premises this statement on studies indicating that "stocks with lower proportionate dividend payouts do not sell at higher prices than do stocks of equivalent enterprises with higher proportionate payouts, and that in some degree the reverse is true."[39] Further, Brudney asserts that studies of management behavior demonstrate that firms will generally establish target payout ratios and then pursue a stable dividend policy.[40] This pattern provides further empirical support, in Brudney's view, for the proposition that dividend policy has an independent effect on share values.[41]

When viewed in its entirety, however, the empirical evidence does not support the proposition that shareholders prefer dividends. Indeed, recent studies have generally rejected this conclusion. Thus Litzenberger and Ramaswamy,[42] Rosenberg and Marathe,[43] and Stone and Bartter[44] have all found evidence of

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[36] *See* R. BREALEY, *supra* note 23, at 7.

[37] *See* Brudney, *supra* note 1, at 89.

[38] *Id.* at 90.

[39] *Id.* at 90-91 (footnotes omitted).

[40] *See id.* at 89-90.

[41] *See id.* at 98.

[42] *Dividends, supra* note 34; *Personal Taxes, supra* note 34.

[43] B. Rosenberg & V. Marathe, Test of Capital Asset Pricing Hypothesis (unpublished draft of an article to appear in J. FINANCIAL RESEARCH) (copy on file with the Virginia Law Review Association).

[44] B. Stone & B. Bartter, The Effect of Dividend Yield on Stock Returns: Empirical Evidence on the Rolevance of Dividends (Working Paper No. E-76-8, Georgia Institute of Tech-

what appears to be a dividend aversion on the part of the investing public. Black and Scholes,[45] and later Miller and Scholes,[46] although concluding that the evidence does not support the notion of a dividend aversion coefficient, found no evidence of shareholder preference for dividends. Numerous recent empirical studies, in short, contradict Brudney's assertion that empirical evidence demonstrates that shareholders prefer dividends to retention.[47]

Nor does empirical evidence that firms tend to establish target ratios and otherwise follow a stable dividend policy indicate that shareholders prefer dividends. A target payout ratio can be either a high or low percentage of earnings. That a firm pays out only a small percentage of earnings every year does not prove that management believes shareholders have a preference for dividends. Target ratios may reflect management's belief that a consistent dividend policy is valued by investors, but shareholder preference for a consistent dividend policy does not establish that shareholders prefer dividends to retention.

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nology) (copy on file with the Virginia Law Review Association).

[45] Black and Scholes, *supra* note 35.

[46] Miller and Scholes, *supra* note 35.

[47] In addition to studies cited in notes 42-46 *supra*, see Gordan & Bradford, Taxation and the Stock Market Valuation of Capital Gains and Dividends: Theory and Empirical Results (Working Paper No. 409, National Bureau of Economic Research) (March 1980) (finding no systematic difference in the valuation of dividends and capital gains). Even some of the earlier studies cited by Brudney for the proposition that sharebolders favor dividends do not stand for that proposition. Brudney, for example, cites R. BREALEY, *supra* note 23, at 16, as a study indicating that stocks with higher proportionate payouts sell at a higher price than stocks with lower proportionate payouts. *See* Brudney, *supra* note 1, at 91 n. 15. In fact, however, Brealey states that one study found that the market valued dividends slightly higher than retained earnings, but that this study contained serious methodological flaws. *See* R. BREALEY, *supra*, at 16.

There is, however, some recent empirical support for Brudney's conclusion that investers prefer dividends to retention. *See* Blume, *Stock Returns and Dividend Yields: Some More Evidence*, 62 REV. ECON. & STAT 567 (1980). Blume concludes that "[i]n the three decades ending in 1976, those stocks with anticipated yields in excess of the mean marketwide yield outreturned nondividend paying stocks at each level of beta." *Id.* at 577. The force of Blume's conclusion must be discounted, however, because of his focus on nondividend paying stocks. Firms that pay no dividends may not provide a representative sample for testing invester preference for dividends, because a disproportionately high percentage of these firms are either small or unsuccessful. It is possible, therefore, that Blume's findings are attributable to factors other than dividend policy. I am indebted to Professor Merton H. Miller for this observation. *See also* Long, *The Market Valuation of Cash Dividends*, 6 J. FINANCIAL ECON. 235 (1978) (case study finding investor preference for cash dividend).

Moreover, a stable dividend policy may be explained by the clientele effect.[48] This clientele effect suggests that although there may be no universally "optimal" level of payout, each company should attempt to pursue a stable dividend policy to suit its particular "clientele."[49] Under this theory, short-run departures from the target ratio should be avoided because of the costs that such changes would impose on the firm's investors. Such departures should only be undertaken where the firm expects the new level of dividend payout to be continued or, perhaps, where the firm wants to use dividend policy as a signal of future prospects to investors.[50]

E. The Information Content of Dividends: The Signaling Hypothesis

Even if Brudney's conclusion that dividend policy affects share prices apart from earnings is rejected, it does not necessarily follow that a change in dividend policy by a particular firm will have no effect on the market price. If investors perceive the dividend decision as containing information about the firm's future prospects, a price change will result. Thus, although a shift in dividend policy might provide the occasion for a price change because of the information communicated, it would not be the cause of the change.[51] The price changes because of investors' altered expectations about the firm's future earnings and growth opportunities.[52]

Assuming that management possesses inside information about the firm's expected cash flows, it may fairly be asked why dividend policy would be used as the vehicle to convey the message. There are several possible explanations for why management may use dividend policy to convey inside information about the firm's prospects rather than stating the information directly. One such explanation is that cash dividends are reliable signals of profitability because they are taxed at a higher rate than capital gains and are, therefore, costly to a firm. Dividends are thus a more efficient sig-

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[48] *See* T. Copeland & J. Weston, *supra* note 8, at 352.

[49] The notion that investors in different tax brackets should have different dividend preferences and that firms should consider these preferences in setting dividend policy has been challenged by Black and Scholes and later by Miller and Scholes. *See* note 35 *supra* and accompanying text.

[50] *See* notes 51-57 *infra* and accompanying text.

[51] *See* Miller & Modigliani, *supra* note 12, at 430.

[52] *See id.*

nal than other sources of information such as accountants' reports or other forms of disclosure that are unreliable screening mechanisms because of the moral hazard of communicating profitability.[53] A related possibility is that the dividend signal, unlike various forms of disclosure, "cannot be mimicked by unsuccessful firms, because they do not have the cash flow to back them up."[54] Yet another possibility is that, because dividend decisions are almost solely at management's discretion, announcements of dividend changes should provide less ambiguous information than other possible signaling mechanisms such as earnings information.[55] For all these reasons, management might decide to use dividend policy as a signal, because it is a more reliable and, therefore, more efficient signal than other possible means of communicating information.[56]

The empirical evidence also appears to support the signaling hypothesis. If dividend changes are to serve as effective siguals, they must convey information about future cash flows not provided by other sources. The several studies that have tested the signaling hypothesis empirically have generally concluded that dividends do convey useful information about a firm's prospects.[57] Thus, both theory and empirical evidence seem to indicate that, although dividend policy has no independent impact on the value of the firm's shares, changes in dividend payout frequently convey new information about the prospects of the firm.

II. Management's Incentives in Making the Dividend Decision

Even if Professor Brudney's conclusion that dividend policy af-

[53] *See* Bhattacharya, *Imperfect Information, Dividend Policy, and "The Bird in the Hand Fallacy,"* 10 Bell J. Econ. & Management Sci. 259, 260 (1979).

[54] *See* T. Copeland & J. Weston, *supra* note 8, at 345.

[55] *See* Aharony & Swary, *Quarterly Dividend and Earnings Announcements and Stockholders' Returns: An Empirical Analysis,* 35 J. Finance 1 (1980).

[56] In arguing for mandatory disclosure to clarify the inherent ambiguity of the dividend message, Brudney ignores the dividend signal's efficiency and managers' incentives to tell the truth. *See* notes 91-100 *infra* and accompanying text.

[57] *See, e.g.,* Aharony & Swary, *supra* note 55; Pettit, *Dividend Announcements, Security Performance, and Capital Market Efficiency,* 27 J. Finance 993 (1972). *But cf.* Watts, *The Information Content of Dividends,* 46 J. Bus. 191 (1973) (suggesting that the information content of dividends is insignificant). The evidence is summarized in T. Copeland & J. Weston, *supra* note 8, at 359-62.

fects share prices apart from earnings were accurate, it would not necessarily follow that shareholders would be prejudiced by management's control of dividend policy. If management is dedicated to the goal of maximizing sbarebolder wealth, it will simply take the impact of its dividend policy on share prices into account in making the dividend/investment decision. Brudney, however, rejects this shareholder wealth-maximizing model of management decisionmaking. Rather, he argues that "institutional arrangements may operate to tempt management or owners of control to make dividend decisions more or less systematically in their own rather than the public investors' best interests."[58] It is necessary, therefore, to analyze the extent to which management has a conflict of interest in making the dividend decision.

A. *Management's Alleged Preference for Growth in Size Over Growth in Profits: The Managerialist Hypothesis*

Brudney suggests that management's systematic bias in favor of retention may be explained by "its preference for growth in sales and size (and associated managerial perquisites) over growth in profits."[59] This application of the managerialist theory assumes that managers tend to maximize sales, staff, perquisites, prestige, power, and related self-aggrandizing factors rather than maximizing the corporation's present worth for the shareholders' benefit.[60] The argument is a variant of the classic Berle-Means thesis that the separation of ownership and control in large publicly held corporations results in non-profit-maximizing behavior by managers to the detriment of shareholders.[61]

There are several problems with Brudney's adoption of the managerialist model to explain a conflict of interest that causes

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[58] Brudney, *supra* note 1, at 107 (footnote omitted).

[59] *Id.* at 95 (footnote omitted).

[60] For examples of the managerialist model, see W. BAUMOL, BUSINESS BEHAVIOR, VALUE AND GROWTH 15-79 (rev. ed. 1967); R. MARRIS, THE ECONOMIC THEORY OF "MANAGERIAL" CAPITALISM (1964); Marris & Mueller, *The Corporation, Competition, and the Invisible Hand*, 18 J. ECON. LITERATURE 32 (1980) (surveying the relevant literature).

[61] *See* A. BERLE & G. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY (rev. ed. 1968). The Berle-Means thesis has been the subject of much discussion. For a recent and powerful critique, see Fama, *Agency Problems and the Theory of the Firm*, 88 J. POL. ECON. 288 (1980). *See also* Jensen & Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FINANCIAL ECON. 305 (1976).

managers not to pay dividends. First, this description of management behavior is somewhat inconsistent with the description in other parts of Brudney's article. Brudney supports his initial argument that dividends have an impact on share prices, for example, by emphasizing the "continued managerial deference to perceived stockholder preference for dividends."[62] He notes that this deference may at times be so strong that management will "subordinate investment decisions to a constant dividend policy."[63] To support his conflict of interest argument, however, Brudney points to a systematic tendency of management *not* to pay dividends.[64] These inconsistent descriptions of management behavior cannot be reconciled.

Second, the managerialist conflict of interest model has very little to do with dividend policy. The supposed problem is that management will make undesirable investments to maximize growth at the expense of profits, not that management will prefer a policy of retained earnings to distribution. If management is dedicated to growth at the expense of profits, it can achieve that growth regardless of its dividend policy. The firm could pay dividends and finance its investments with new equity capital rather than with retained earnings.[65] Indeed, if, as Brudney argues, a high dividend payout does increase the price of shares, a firm dedicated to

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[62] Brudney, *supra* note 1, at 90.

[63] *Id.* at 89 (footnote omitted). Brudney acknowledges that in theory it is untenable that dividend policy might cause management to forgo an attractive investment given other financing alternatives. He argues, however, that in practice the conflict of interest between management and stockholders may make these alternatives unattractive and the investment may in fact be forgone. *See id.* at 89 n.11.

[64] *See id.* at 94.

[65] This statement assumes an absence of market constraints on managerial behavior. In reality, management would have great difficulty selling new equity to finance unprofitable investments. Strong market checks (ignored by the managerialists) also limit management's ability to finance unprofitable investments with retained earnings. *See* notes 71-75, 78-79 *infra* and accompanying text.

Empirical studies have reached differing results on the question whether investments financed with retained earnings are less profitable than investments financed externally. *Compare* Baumol, Haim, Malkiel, & Quandt, *Earnings Retention, New Capital and the Growth of the Firm*, 52 REV. ECON. & STATISTICS 345 (1970), *with* Friend & Husic, *Efficiency of Corporate Investment*, 55 REV. ECON. & STATISTICS 122 (1973) *and* Racette, *Earnings Retention, New Capital and the Growth of the Firm: A Comment*, 55 REV. ECON. & STATISTICS 127 (1973) *and* Whittington, *Profitability of Retained Earnings*, 54 REV. ECON. & STATISTICS 152 (1972). *See also* Baumol, Haim, Malkiel & Quandt, *Efficiency of Corporate Investment: A Reply*, 55 REV. ECON. & STATISTICS 128 (1973).

growth at the expense of profits would probably maintain a high payout ratio because it could raise capital to finance growth more quickly by selling more highly valued stock.[66] The shareholder, according to Brudney, therefore faces the risk that management will prefer growth to earnings regardless of the firm's payout policy.[67] Application of the managerialist conflict of interest model to dividend policy thus confuses dividend policy with investment policy.

Third, empirical evidence does not support the managerialist model. For example, if the managerialist model were accurate, one would predict that the market would interpret a takeover as empire building by the acquiror rather than as a value-maximizing combination, thus causing share prices of the acquiror to fall. This, however, has not been the case. Stock prices of acquiring firms, net of market movements, tend either to be stable or to increase in anticipation of a takeover.[68] Studies of management compensation have also contradicted the managerialist model.[69] These studies have concluded that profitability, rather than growth or other variables, determines managerial compensation. Management does not benefit from maximizing growth; it benefits from maximizing profits and thus shareholder welfare.[70]

What Brudney and the managerialists in general have failed to appreciate adequately are the market constraints on management

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[66] Brudney himself argues that a high dividend payout would lower the cost of raising capital: "By withholding dividends management presumably (because of shareholder dividend preference) depresses stock prices and thus raises its cost of capital by some indeterminate amount." Brudney, *supra* note 1, at 99.

[67] For small firms, however, flotation costs might make it somewhat easier for management to finance undesirable investments with retained earnings.

[68] *See, e.g.*, Dodd & Ruback, *Tender Offers and Shareholder Returns*, 5 J. FINANCIAL ECON. 351 (1977); Ellert, *Mergers, Antitrust Law Enforcement and Stockholder Returns*, 31 J. FINANCE 715 (1976); Madelker, *Risk and Return: The Case of Merging Firms*, 1 J. FINANCIAL ANALYSIS 303 (1974). For a critical discussion of the the managerialist theory of mergers and takeovers, see Easterbrook & Fischel, *The Proper Role of a Target's Management In Responding to a Takeover*, 94 HARV. L. REV. 1161, 1185-88 (1981) (discussing the empirical evidence).

[69] *See* W. LEWELLEN, EXECUTIVE COMPENSATION IN LARGE INDUSTRIAL CORPORATIONS (1968); Lewellen & Huntsman, *Managerial Pay and Corporate Performance*, 60 AM. ECON. REV. 710, 716-19 (1970) (empirical evidence showed that management compensation depends heavily on the generation of profits).

[70] If management in fact heneflted from self-aggrandizement rather than from maximizing profits, it could fairly be asked why any rational person would ever hecome a shareholder, given the wealth of alternative investment opportunities. The managerialists provide no satisfactory answer to this question.

discretion. The underlying assumption in Brudney's analysis appears to be that managers have the ability to raise share prices merely by altering dividend policy, but resist because of some perceived conflict of interest. This assumption is implausible on its face. If it were in fact possible for management to raise the price of the firm's shares by simply altering dividend policy, it would have every incentive to do so.

Whether to declare a dividend and the amount of such dividend are among the countless decisions managers must make as agents for shareholders.[71] An inefficient dividend decision is no different than any other suboptimal managerial decision. If managers adopt a lower (or higher) payout policy than shareholders desire, the price of the firm's stock will trade at a lower price than otherwise identical firms with different dividend policies. The firm will thus be disadvantaged in attracting equity capital. Managers who make such suboptimal dividend (or other corporate) decisions will thereby reduce the value of their services.[72] The resulting inefficiencies will also make it more difficult for the firm to compete in the product market.

If a firm's share price falls far enough as a result of suboptimal dividend policy, the firm will become a likely candidate for a proxy fight or a tender offer. Indeed, a tender offer would be a particularly attractive possibility. By acquiring control through equity ownership, an offeror could appropriate to itself the gains that would result from simply altering the dividend policy.[73] The risk of such a takeover attempt provides management with an incentive to set dividend policy in the best interests of its shareholders.[74] Man-

[71] Because the incentives of an agent will invariably diverge from those of the principal, there are certain agency costs inherent in the shareholder-manager relationship. *See* Easterbrook & Fischel, *supra* note 68, at 1168-74. Various market constraints, however, severely limit management's ability to further its own interests to the detriment of shareholders. *See id.* at 1196-97; notes 72-75 *infra* and accompanying text.

[72] On the critical significance of the market for managerial services as a check on suboptimal management, see Fama, *supra* note 61.

[73] *See* note 13 *supra.*

[74] The incentive to operate efficiently and to minimize suboptimal management is decreased if managers can pursue a defensive strategy to thwart a takeover attempt. *See* Easterbrook & Fischel, *supra* note 68. The Williams Act, 15 U.S.C. §§ 78g, 78l-78n, 78s (1976), *as amended by* Foreign Corrupt Practices Act of 1977, Pub. L. No. 95-213, 91 Stat. 1494 (1977), and state takeover statutes, however, have had the effect of decreasing the incentive of managers to act in the best interests of shareholders by raising the cost of takeovers. *See* Fischel, *Efficient Capital Market Theory, The Market For Corporate Control, and the*

agers who do not respond to this incentive will be replaced by more capable managers who will pursue a preferable dividend policy.

B. Other Explanations for Management's Alleged Systematic Bias in Favor of Retention

Professor Brudney offers two additional arguments for the existence of a conflict of interest between managers and shareholders. The first is that a management that owns stock options may act to the detriment of shareholders.[75] The second argument is that a controlling shareholder may create personal tax advantages for himself by withholding or reducing dividends to the detriment of other shareholders.[76] In both situations, Brudney asserts, insiders can profit at the expense of the public shareholders.[77] Neither explanation for the alleged conflict of interest is convincing.

It is not at all clear, for example, that a management that owns stock options will act to the detriment of shareholders. It is conceivable that managers who own stock options may decide to forgo a dividend in the expectation that the stock price will increase, making their options more valuable. There are severe limits, however, on management's ability to further its own interest at the expense of shareholders in this manner. Retention has no impact on shareholders;[78] what is relevant is how retained earnings are used. If they are used unprofitably, the price increase as a result of retention will be less than the amount of the forgone dividend. If such a policy becomes known to investors (as it would if it were repeated), the stock price would fall rather than rise because comparable firms would become more attractive investments. Although this would injure the firm's shareholders, it would also decrease the value of management's stock options. The existence of stock

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Regulation of Cash Tender Offers, 57 Tex. L. Rev. 1 (1978). *See generally* Jarrell & Bradley, *The Economic Effects of Federal and State Regulation of Cash Tender Offers*, 23 J.L. & Econ. 371 (1980).

[75] *See* Brudney, *supra* note 1, at 123.

[76] *See id.* at 123-24.

[77] *See id.* at 124.

[78] Shareholders who desire current income can sell part of their holdings. Although this would cause them to incur transactions costs, these costs must be balanced against the tax consequences of declaring a dividend as well as flotation costs if funds are needed for investment.

options, therefore, probably does not alter management's incentive to set dividend policy in the best interest of the shareholders, nor does it create any significant conflict of interest between managers and shareholders.

The argument that a conflict of interest exists because a controlling shareholder may create personal tax advantages for itself by withholding or reducing dividends to the detriment of other shareholders is also unpersuasive.[79] Initially, it should be noted that the existence of a controlling shareholder cannot explain management's alleged systematic bias in favor of retention. If the controlling shareholder is a corporation, for example, it would create a personal tax advantage by causing the firm to increase dividends rather than to withhold or reduce them. More important, so long as the firm's dividend policy is consistent, no conflict is likely to exist. Insofar as the clientele effect occurs,[80] the firm will attract a clientele of shareholders with a substantial identity of interests.[81] Even if the dividend change is unexpected and for the purpose of providing a tax advantage to a controlling shareholder, minority shareholders need not suffer substantial prejudice. They can simply sell part of their holdings to obtain current income.

C. The Appropriateness of Judicial Noninterference with the Dividend Decisionmaking Process: The Business Judgment Rule

As demonstrated above, managers have no significant incentive to act contrary to the best interests of shareholders in setting dividend policy. Any systematic suboptimal dividend policy will have negative consequences in the managerial services market, the capital market, the product market, and, if prolonged, may trigger a proxy fight or a takeover. With such powerful market forces controlling management discretion, there will rarely, if ever, be a need

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[79] To the extent that a controlling shareholder can create personal tax advantages by altering dividend policy, it is equally plausible that dividends could be increased rather than withheld or reduced. The controlling shareholder situation, therefore, cannot explain management's alleged systematic bias in favor of retention.

[80] *Compare* sources cited note 34 *supra with* sources cited note 35 *supra.*

[81] Stock picking on the basis of dividend policy is inconsistent with modern portfolio theory, which emphasizes the importance of diversification. *See* Black & Scholes, *supra* note 35 and accompanying text. For the investor who holds a diversified portfolio without regard to the dividend policy of a firm, changes in one firm's dividend policy will in all probability be offset by other changes by other firms and have no net effect.

for courts to entertain challenges to the dividend policy of a publicly held corporation's management.[82]

Courts have typically followed this approach. Invoking the business judgment rule, courts have generally held that the decisions concerning the issuance and amount of a dividend are entrusted solely to the discretion of the board of directors.[83] Shareholder suits challenging management dividend policy in large corporations have, therefore, been almost uniformly unsuccessful.[84]

Applying the business judgment rule to the dividend decision maximizes shareholder welfare. The rule's fundamental rationale is that managers are better equipped to make business decisions than uninformed and inexperienced judges or shareholders.[85] Although a court may occasionally be able to detect inferior decisionmaking or some other suboptimal management, a legal rule that facilitated judicial interference would undoubtedly cause a net loss for shareholders.[86] Moreover, the ratio of suits to even possible improvements would be high because plaintiff shareholders, like courts, lack the information necessary to challenge managerial decisions intelligently.

Application of the business judgment rule is particularly appropriate in the dividend context. Management may base the dividend decision on a variety of factors. Examples of determinative factors might include whether funds are needed for investment, payment of creditors, or maintenance and upkeep of existing facilities, and

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[82] *See* Manne, *supra* note 9, at 280.

[83] *See, e.g.*, 7 Z. Cavitch, Business Organizations with Tax Planning § 141.02 [1] (1980) (collecting cases) ("It is a fundamental rule of corporate law that it is solely within the province of the board of directors to determine (1) at what time and (2) to what extent a dividend shall be paid.").

[84] *See, e.g.*, Baron v. Allied Artists Pictures Corp., 337 A.2d 653 (Del. Ch. 1974); Berwald v. Mission Dev. Co., 40 Del. Ch. 509, 185 A.2d 480 (1962); American Dist. Tel. Co. v. Grinnell Corp., 33 A.D.2d 769, 306 N.Y.S.2d 209 (1969).

[85] *See* Easterbrook & Fischel, *supra* note 68, at 1195-97.

[86] Professor Brudney accepts the business judgment rule as the proper standard of review in analyzing the dividend decision. *See* Brudney, *supra* note 1, at 104. The presumption that managers are better able to make business decisions than shareholders or judges is far less strong when management is faced with a clear conflict of interest. For this reason, courts scrutinize more closely transactions involving possible self-dealing. Generally, the business judgment rule does not apply in these situations. *See* Easterbrook & Fischel, *supra* note 68, at 1197. One of the central themes of Brudney's thesis is that the dividend decision does present managers with a conflict of interest. *See* text accompanying note 3 *supra*. If Brudney were correct that management has a clear conflict of interest in making the dividend decision, it would follow that the business judgment rule should be inapplicable.

whether needed funds can be cheaply or readily obtained from the capital market. The identity of the firm's clientele and their respective tax situations, and the signals management might want to communicate to its investors about the firm's future prospects are also possible determinative factors. Decisions based upon these factors are particularly within the competence of management, which has every incentive to make the dividend decision in the best interest of shareholders. Under these circumstances, any judicial second-guessing of the dividend decision is likely to reduce shareholder welfare.

III. Mandatory Disclosure of the Reasons Underlying the Dividend Decision

After concluding that dividend policy has an effect on share prices independent of earnings and that there is a conflict of interest between managers and shareholders that might influence the dividend decision, Professor Brudney proposes that management be required in certain circumstances to disclose the reasons for its dividend decision.[87] Such mandatory disclosure, in Brudney's view, would minimize the conflict of interest between managers and shareholders by policing management's discretion with respect to the dividend decision and would encourage more "correct" stock prices by eliminating the ambiguity inherent in the dividend decision.

These arguments in favor of mandatory disclosure are unpersuasive. The first justification—premised on a purported conflict of interest that, at least with respect to large, publicly held corporations, does not exist[88]—requires no further discussion.[89] The second justification assumes that the dividend decision misleads investors and that mandatory disclosure would provide investors with more accurate information. As discussed below,[90] neither of these assumptions is valid. In addition, Brudney underestimates the costs that would result from the implementation of his

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[87] These circumstances are discussed at notes 103-12, 117-18 *infra* and accompanying text.

[88] *See* notes 59-75, 78-81 *supra* and accompanying text.

[89] I will, however, discuss some of the practical difficulties associated with Brudney's mandatory disclosure proposal in the conflict of interest context. *See* notes 117-18 *infra* and accompanying text.

[90] *See* notes 91-102 *infra* and accompanying text.

mandatory disclosure proposal.

A. *The Ambiguity of the Dividend Message*

Brudney appears to endorse two distinct rationales to explain why the dividend message is ambiguous. At certain points, he suggests that the ambiguity derives from the inequality of access various investors have to relevant information. Thus, he states that "the theoretically possible ambiguities or contradictions of the dividend action may not in fact materialize in the investment community. The delphic language of dividend action may be clear to those to whom it matters."[91] He argues, however, that this clarity will not be apparent to noninstitutional investors because

> the facts on which dividend action is based are not equally available to all members of the public. Thus, institutional investors presumably have better access—both by reason of contacts and by reason of expenditures for research—than do small individual investors to information that will fill out the message given by the dividend actions.[92]

This unequal-access-to-information rationale for disclosure reflects a lack of understanding of the operation of efficient capital markets such as American stock markets.[93] An efficient capital market is one in which all available information is fully and almost instantaneously reflected in share prices.[94] The constant attempt by institutional investors, securities analysts, and other market professionals to identify mispriced securities and trade on this information is the process by which capital markets become efficient. It is absolutely irrelevant whether every investor has access to this same information. As long as the information is embedded in stock prices, which is a certainty if institutional investors have access to

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[91] Brudney, *supra* note 1, at 112.

[92] *Id.* at 109 n.72.

[93] There is an enormous and growing body of literature on the efficient capital markets hypothesis, which supports the proposition that American stock markets are efficient. For an excellent basic treatment of the theory and the evidence, see J. Lorie & M. Hamilton, *supra* note 15, at 70-110. *See also* Fama, *Efficient Capital Markets: A Review of Theory and Empirical Work,* 25 J. Finance 383 (1970); Jensen, *Capital Markets: Theory and Evidence,* 3 Bell J. Econ. & Management Sci. 357 (1972); Note, *The Efficient Capital Market Hypothesis, Economic Theory and the Regulation of the Securities Industry,* 29 Stan. L. Rev. 1031, 1034-57 (1977).

[94] *See* J. Lorie & M. Hamilton, *supra* note 15, at 97.

it, small investors cannot be deceived. Conversely, small investors are in no way benefited by disclosure because the information disclosed is already imbedded in share prices. By accepting the price, all shareholders, large and small, are fully protected.[95]

The more interesting basis for disclosure advanced by Brudney is the ambiguity of the dividend message when dividends are used as a signal of future earnings. The signaling hypothesis assumes that management, by virtue of its monopolistic access to inside information, is able to use dividend policy as a signal of future prospects. Brudney suggests that the dividend decision may be ambiguous in this situation because no outsider, institutional investor or otherwise, has access to the reasons underlying the dividend decision.

Although more plausible than the unequal access rationale, this justification for mandatory disclosure is ultimately unconvincing. If the dividend decision is ambiguous, one may fairly ask why a firm would employ a signaling mechanism that is inefficient—one that confuses investors. Indeed, if dividends, coupled with disclosure, provide a more efficient signaling device than dividends alone, one would predict that firms would habitually make such desired disclosure voluntarily.[96] Firms that refused to use the most efficient signaling mechanism would be less desirable to investors and would suffer various market penalties as a result.[97]

In light of the market pressures to employ an efficient signaling device, managers could be expected to use dividend policy to mislead investors only if (1) they could gain thereby, and (2) they could in fact mislead investors. Both of these conditions merit close scrutiny.

Managers have no incentive to mislead investors when the underlying iuformation is positive. Because management compensation is linked to the success of the firm, managers have every incentive to communicate positive information. Managers arguably have less incentive to signal accurately when the underlying information is negative. In this situation, managers might want to mis-

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[95] Much of the mandatory disclosure required by the federal securities laws is of dubious benefit to investors for this very reason. For a comprehensive discussion of this point, see Note, *supra* note 93.

[96] Voluntary dividend disclosure is in fact quite common.

[97] *See* notes 72-75 *supra* and accompanying text.

lead investors by hiding bad news or even possibly by faking good news. By either raising or not lowering the dividend in this situation, managers could conceivably use dividend policy to disguise the negative information.[98]

Both general market constraints and the nature of the dividend signal, however, provide significant counterincentives. If a manager's only concern were a misleading signal's short term impact, he might well decide to signal falsely. Managers, however, do not have such a limited time horizon. The manager must not only be concerned with the effect false signaling will have on his current compensation, but also with the effect it will have in the future. Thus, the manager must balance the immediate gains of false signaling against the potential long-term losses.[99] Not only will any short term benefit disappear once the underlying results are revealed, but the reliability of the firm's use of dividend policy as a signaling device will be dramatically reduced. Assuming that investors desire accurate signaling, a manager who conveys inaccurate signals will thus decrease the value of his services. In sum, therefore, although there are some incentives to convey inaccurate signals with respect to negative information, there are also significant disincentives.

Wholly apart from the question of incentive, it is far from clear that the risk that investors will actually be misled by the dividend decision is serious enough to warrant the imposition of costly disclosure requirements. Dividends are not evaluated in isolation. In evaluating a firm's future propsects, investors look at dividends in conjunction with a multitude of data including earnings and cash flow information, industry reports, and voluntary disclosures by management. If these factors belie the dividend signal, managers will be unable to mislead investors with the dividend message. For example, if earnings and cash flow information are negative, a divi-

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[98] Management will not be able to mislead investors by simply disclosing positive, but not negative, information. If good news brings disclosure, investors infer that no disclosure means bad news. *See* Grossman & Hart, *Disclosure Laws and Takeover Bids,* 35 J. FINANCE 323 (1980).

[99] Management's incentive to manipulate dividend policy to conceal negative information is further reduced if, as is probable, any such manipulation will aggravate the underlying condition. Thus, given the flotation costs of obtaining necessary capital by selling new equity, failure to lower dividends in the face of reduced earnings only worsens the firm's financial condition.

dend increase will in all probability fail to inspire investor confidence in the firm's future prospects.[100] Even if the dividend signal does cause movement in a firm's stock price, unwarranted by developments in earnings, this movement will be only temporary. When it becomes clear that the firm's cash flow and earnings do not support the dividend signal, the firm's share price will return to the presignal level. Mandatory disclosure's potential contribution to "correct" stock pricing, therefore, seems minor, if not insignificant.

B. The Problem of Corporate Secrecy

Brudney's mandatory disclosure proposal is intended to benefit investors by making the dividend message less ambignous and by minimizing management conflicts of interest. In some circumstances, however, mandatory disclosure of the reasons underlying the dividend decision would greatly prejudice the firm's shareholders, the very group Brudney seeks to protect with his disclosure proposal.

The famous case of *SEC v. Texas Gulf Sulphur Co.*[101] provides a classic illustraton of a situation where mandatory disclosure would not be in the shareholders' best interests. In that case, a firm had undertaken a massive mineral rights acquisition program because it believed that drilling would reveal valuable mineral deposits. Suppose that the firm had decided to finance its land acquisitions with retained earnings and, therefore, had cut or eliminated its dividend. Assume further that the only disclosure made by the firm at the time of the dividend decision was that the funds were needed for investment and expansion. Would the firm's shareholders be benefited by a rule that required management to disclose the reasons for its action? The answer seems to be that they would not. The primary beneficiary of disclosure of the reasons underlying the dividend decision would not be the firm's shareholders but the firm's competitors and the sellers of the mineral rights. Such disclosure would no doubt make it virtually impossible for the firm

[100] Indeed, the unsuccessful firm's inability to mimic a positive dividend signal lessens management's incentives to attempt to mislead investors. *See* T. COPELAND & J. WESTON, *supra* note 8, at 345.

[101] 401 F.2d 833 (2d Cir. 1968), *cert. denied,* 394 U.S. 976 (1969). *See* Scott, *Insider Trading: Rule 10b-5, Disclosure and Corporate Privacy,* 9 J. LEGAL STUD. 801 (1980).

to complete the acquisition program; at the very least, it would become prohibitively expensive. The rational shareholder of the mining company in *Texas Gulf Sulphur,* therefore, would view mandatory disclosure of the reasons underlying the dividend decision as contrary to his self-interest.

There are, of course, many other such examples. Whenever disclosure of the reasons for the dividend decison will aid investors, and no corporate policy such as protection of valuable business opportunities will be sacrificed, the firm has every incentive to disclose voluntarily. It is precisely in those situations where the firm does not disclose voluntarily, however, that there is the greatest risk that mandatory disclosure will hurt shareholders by providing valuable information to competitors.[102]

C. Practical Problems with Brudney's Mandatory Disclosure Proposals

Brudney rejects a general disclosure requirement on the ground that the benefits might not exceed the costs.[103] He, proposes, however, that disclosure should be required (1) when the dividend decision is particularly likely to mislead,[104] and (2) when the dividend decision presents a particularly "serious" conflict of interest.[105] The difficulties with these two suggestions are examined below.

1. Mandatory Disclosure When the Dividend Decision Is Particularly Likely to Mislead

If disclosure is to be required only in those situations where the dividend decision is likely to be misleading, it is necessary to identify precisely what those situations are. Although Brudney does not resolve this question definitively,[106] he offers several alterna-

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[102] Brudney at one point states that mandatory disclosure "need not be so detailed as to inform competitors." Brudney, *supra* note 1, at 118. This point is lost, however, in the long discussion on the need to clarify the dividend message to avoid misleading investors. *Id.* at 108-14, 117-22. One may fairly ask how much benefit to investors would result from disclosure that is too general to be of assistance to competitors. *See* notes 103-119 *infra* and accompanying text.

[103] Brudney, *supra* note 1, at 116-18.

[104] *See id.* at 119-22.

[105] *See id.* at 122-24.

[106] Brudney suggests that the Securities and Exchange Commission should resolve the matter after an empirical study. *See id.* at 120 & n.104.

tive guidelines for when disclosure might be required. His first, and apparently preferred,[107] suggestion is that disclosure should be required "in those circumstances in which the action would be likely to be inconsistent (on conventional assumptions about investor reaction) with evidence reasonably available to, or estimates or opinions reasonably held by, management."[108] Thus "an increase in dividends might be proscribed as deceptive or misleading if made without a full explanation when management does not have reasonable grounds to expect any material increase in earnings over the previous periods."[109] Conversely, "a reduction of the dividend without adequate explanation would be deemed misleading if made when management has no reasonable grounds to expect any decrease in earnings."[110] As an alternative, Brudney proposes that disclosure should be required only in "more objectively determinable circumstances."[111] Under this objective test, disclosure would be required if there had been a change in dividend policy without a corresponding change in earnings in the past one or two earnings periods.[112]

Aside from being premised upon the incorrect assumption that management has the incentive and the ability to mislead the firm's investors,[113] implementation of either of these guidelines would be difficult, if not impossible, and would therefore create substantial and unnecessary administrative costs. Brudney's preferred "reasonable grounds" test is particularly objectionable in this regard because of the uncertainty it would create. How is the reasonableness of management's expectation of either an increase or decrease in earnings to be determined? The "objective" test has less uncertainty, but is also less useful to investors because it is based on past performance rather than on future prospects, the determinant of stock price.

The proposal also fails to insure adequate disclosure. Brudney complains about the adequacy of voluntary disclosure,[114] but there

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[107] *See id.* at 120 n.104.
[108] *Id.* at 119.
[109] *Id.*
[110] *Id.*
[111] *Id.*
[112] *See id.*
[113] *See* notes 98-100 *supra* and accompanying text.
[114] *See* Brudney, *supra* note 1, at 112-13.

is no assurance that mandatory disclosure will result in anything other than the same noninformative boilerplate statements. Indeed, because of the complexity of the factual basis for the dividend decision and for management's expectations concerning future earnings, the only alternative to a boilerplate statement in many cases will be an unwieldy essay that would tend to confuse as much as enlighten. There is no assurance, in short, that mandatory disclosure would clarify any ambiguity of the dividend message that existed.

The uncertainty created by the question of adequacy of disclosure, as well as other questions such as whether the "reasonable grounds" test has been met, would, however, have serious adverse consequences. Implementation of the suggested guidelines would likely result in a flurry of lawsuits after every dividend decision, challenging the accompanying disclosure or lack thereof. The range of plaintiffs and the potential exposure of the firm and its management would be limited only by the fortuitous circumstance of who was trading at the time.[115]

Moreover, as Brudney himself concedes, judges are unable to evaluate the issues raised by management's decision whether and to what extent a dividend should be declared.[116] Judicial determination of whether management's disclosure was "correct," however, would require evaluation of essentially the same issues that judges are concededly ill-equipped to make in evaluating the substantive correctness of the dividend decision. Implementation of Brudney's mandatory disclosure proposal would inevitably result, therefore, in a significant number of erroneous decisions, the cost of which will ultimately be borne by shareholders.

2. *Mandatory Disclosure Where the Potential for Conflict of Interest Is "Serious"*

Brudney would also require disclosure in situations involving "clearly visible conflicts over dividend policy."[117] Disclosure of the advantages that insiders derive from the dividend decision that the

[115] The risk of litigation following each dividend decision is likely to deter management, in some situations, from making changes in dividend policy, even when some action would be in the best interests of shareholders.

[116] *See* Brudney, *supra* note 1, at 104-07.

[117] *Id.* at 122.

public does not, as well as the reasons for the dividend decision, will lessen, in Brudney's view, "[t]he temptation for the insider improperly to seek advantages from the disparity in the consequences of the dividend decision."[118]

This proposal suffers from the same practical difficulties as the mandatory disclosure proposal for dividend decisions that are particularly likely to mislead. Management will face great uncertainty in determining whether a litigious plaintiff might be able to assert that a duty of disclosure was owed because a "clearly visible" conflict of interest existed. How is management to know, for example, whether a controlling shareholder has a different tax preference than other shareholders? How is management to know in what situations the ownership of stock options creates a "serious" conflict of interest? Assuming that such a conflict exists, and that it can somehow be determined, it is naive to assume that it will be minimized by a duty of disclosure. More likely, management will issue a boilerplate statement to the effect that the dividend decision is in the best interests of the firm and its shareholders. Again, therefore, implementation of Brudney's proposals would not aid shareholders, but would result in considerable cost and unnecessary litigation.

CONCLUSION

Dividend policy has long presented an enigma to scholars. Many questions concerning dividend policy still await definitive resolution. Professor Brudney has attempted to articulate a coherent theory of dividend policy and the legal rules governing the dividend decision. After surveying the relevant financial and legal literature, he concludes that mandatory disclosure of the reasons underlying the dividend decision is necessary to protect shareholders in those situations where the dividend message is particularly likely to mislead investors and where there exists a serious conflict of interest between management and shareholders. In reaching this conclusion, however, he pays insufficient attention to much of the relevant financial theory and empirical evidence, fails to recognize adequately the market forces that provide managers with an incentive to set dividend policy in the best interests of shareholders, and

[118] *Id.* at 125.

greatly exaggerates the benefits of mandatory disclosure while underestimating its costs. The case for mandatory disclosure, or for any other action limiting management's discretion in making the dividend decision, has not yet been made.