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To Declare or Not to Declare? Should Ontario's Local Electricity Distribution Companies Pay Dividends in the Age of the Pandemic?

By Ron W. Clark, Stephanie D'Amico and Sarah Newman

I Global Trends - A Decline in Dividends

The COVID-19 pandemic has disrupted both public health and economic stability on a global scale. As adverse financial conditions continue, businesses, and some regulators, are turning their attention to the question of whether companies should pay dividends.

At the end of March, the Bank of England's Prudential Regulation Authority advised the cancellation of all dividends and cash bonuses to senior staff to ensure that banks have the requisite liquidity to increase lending to businesses and households during the pandemic. A series of coordinated statements from the country's major financial institutions confirmed the temporary halt on all shareholder payouts. It is notable that the cancellations affected dividends in respect of 2019 financial results as well as going forward into 2020.

With a recession on the horizon, it is not only lenders and financial institutions that will have to keep a short leash on their retained earnings. In the United States, dividends in general are expected to decline as corporations face serious cash flow issues and, in some cases, struggle to stave off insolvency. At the end of March, Goldman Sachs indicated an expected decline of 25% in dividends from S&P 500 companies in 2020.

In Canada, the Office of the Superintendent of Financial Institutions ("**OSFI**") has warned banks not to buy back shares or raise dividends, but has not yet prevented payouts. OSFI has taken other actions to ease the financial pressure on lenders, and has expressly indicated that the resulting additional capital should not be used to increase distributions to shareholders or employees, nor to buy back shares.

Not all regulated entities have received guidance with respect to shareholder payouts during the pandemic. The decision to declare (or not to declare) dividends can be a source of controversy in the best of times for directors. Making that decision against the backdrop of a public health emergency, with potential for additional hardship for shareholders, creates further challenges.

II The Role of the OEB

To date, the Ontario Energy Board (the "**OEB**"), has not issued any guidance on whether or not directors of LDCs should cancel 2019 dividends, prevent 2020 dividends or stop other shareholder payouts. As we have seen above, financial regulators in the U.K. and Canada have taken positions on the payment of dividends by their regulated entities. However, directions by regulators on dividends may be the exception rather than the rule.

The OEB has taken steps to recognize the current situation and the interests of both ratepayers and LDCs. It, along with the Province, has taken steps to protect consumers (no disconnection, arrears management, time-of-use pricing and Low-Income Energy Assistance Program funding increases). For LDCs, the regulator provided them with the option to defer rates that would have been implemented May 1, 2020. Further, LDCs have been given authorization to record additional costs in a deferral account for potential future recovery.

The OEB recognized that there may be costs to distributors associated with implementing the Emergency Order regarding time-of-use pricing. Although it is not expected that these costs will be material, the OEB is allowing distributors to track them, as well as any costs associated with the March 19, 2020 extension of the winter disconnection ban to July 31, 2020 and other costs associated with the COVID-19 pandemic, in a deferral account.

The OEB is also allowing Ontario Power Generation Inc. and Hydro One (and other transmitters) to create a deferral account for (a) lost revenues; and (b) "other costs", covering incremental identifiable costs related to the COVID-19 emergency, including costs relating to bad debt expenses. Presumably, LDCs may expect similar treatment.

The above OEB initiatives signal a balancing of the various interests of shareholders, the LDCs, ratepayers and other stakeholders.

A bedrock principle of regulatory treatment of LDC expenses has been whether such expenses were prudent in light of facts known at the time the investment decision was made. There appears no reason to deviate from the prudency standard, but recognize the unique circumstances in which we find ourselves. It will be important for directors to be up-to-date on the financial condition of the LDC, including movement in receivables, bad debt, cash flow requirements and other financial metrics before declaring a dividend.

III Tests and Thresholds for Declaration of Dividends

(a) Overview

Given the current economic uncertainty, LDCs cannot necessarily rely on their strong financial performance in 2019 to justify declaring dividends, even if they are to be paid out of last year's retained earnings. To complicate matters, municipal shareholders may be counting on dividend income from their LDCs to help finance new and existing municipally-funded community services to respond to the pandemic. Further, municipalities are prohibited from borrowing to fund operating costs. Directors of LDCs who sit on municipal council must be especially mindful of the potential for conflicts of interest surrounding dividend declarations.

In the absence of any official instruction from the OEB, boards of directors of regulated distributors will have to carefully weigh the decision to declare dividends. Faced with a novel set of circumstances, directors should revisit the following familiar and fundamental sources of guidance before deciding whether to make, halt or otherwise alter shareholder payouts: (1) the well-established statutory solvency tests; (2) the LDC's existing dividend policy; and (3) the fiduciary duties of directors.

(b) The Solvency Test

The vast majority of LDCs in Ontario are incorporated under the *Ontario Business Corporations Act* (the "**OBCA**") and, as such, must satisfy the OBCA's two solvency "tests" in order to declare dividends. Subsection 38(3)[1] of the OBCA provides that the directors of a corporation shall not declare a dividend if there are reasonable grounds to believe that:

- the corporation is or, after the payment, would be unable to pay its liabilities as they become due; or
- the realizable value of the corporation's assets would thereby be less than the aggregate of its liabilities and the stated capital of all classes.

Sometimes referred to as the "cash-flow test" and the "net realizable assets test", these two solvency requirements (in varying forms) are also found in the *Canada Business Corporations Act* and the other provincial corporate statutes.

For now, most LDCs are unlikely to find themselves in a position where the declaration of a dividend would breach the statutory solvency requirements. However, these tests may become a live issue as the economic ramifications of the pandemic increase in magnitude. LDCs should also consider whether and to what extent the solvency requirements may be a concern for their unregulated affiliates, whose cash flow may be even less certain.

(c) The Dividend Policy

In many cases, LDCs will have dividend policies in place to govern shareholder distributions. These policies will often stipulate target amounts for dividends, sometimes expressed as a percentage of net income to be paid to shareholders on an annual basis. The obligation (or objective) to pay dividends as contemplated in a dividend policy is rarely absolute. In the ordinary course, the policy will require directors to consider numerous factors before declaring dividends. These factors may include the previously discussed solvency tests as well as budget variances; policies and administrative decisions of the OEB; debt-to-capitalization ratios for both the shareholder and the LDC; the LDC's capital expenditure requirements; the LDC's capital reinvestment needs; tax consequences for the LDC, its affiliates and/or shareholders; and whether the payment of any dividends will adversely affect the LDC's ability to satisfy covenants required by its lenders.

In the wake of COVID-19, some LDCs may wish to amend their dividend policies to build in greater discretion to temper a commitment to pay dividends. This may be particularly important in circumstances where a crisis creates extraordinary economic uncertainty, but does not necessarily place an LDC on the brink of insolvency or default, and does not materially engage the other guiding factors traditionally enumerated in a dividend policy.

(d) Fiduciary Duties of Directors

The OBCA requires directors to act honestly and in good faith with a view to the best interests of the corporation.[2] In discharging their fiduciary duty to act in the best interests of the corporation, directors may consider the interests of a broad range of stakeholders, including shareholders, employees, suppliers, creditors, consumers, government and others.[3] In the case of an LDC, the interests of ratepayers are also a relevant consideration.[4]

Although a director may sometimes be described as a "representative" of a shareholder, it is critical to emphasize that directors are not fiduciaries for shareholders or other stakeholders. In deciding whether to declare (or not to declare) dividends, directors must determine what is in the best interests of the corporation, and not any particular shareholder or other stakeholder, but rather all shareholders and stakeholders as a whole. Directors also have a duty to avoid conflicts of interest, a situation which can often arise where a council member from a municipal shareholder sits on the board of the LDC.

The OBCA also requires directors to exercise the care, diligence and skill of a reasonably prudent person in comparable circumstances when carrying out their duties.[5] The duty of care and, in particular, the concept of "comparable circumstances" may seem difficult to construe in the context of an unprecedented public health emergency, but in actual fact the pandemic does not change the substances of directors' duties. Instead, directors should be prepared for the possibility that there may be new stakeholders to consider (public health authorities, for example) or that there will be new dimensions to the interests of existing stakeholders, including with respect to the declaration of dividends. While COVID-19 colours the analysis in a new way, the guiding inquiry remains the same: is this decision being made with a view to the best interests of the corporation?

IV Conclusions

Directors of LDCs will have to navigate uncharted terrain in deciding whether to declare dividends during the pandemic. In some cases, cancelled, delayed or reduced dividends, or paying dividends in instalments, may be appropriate. In other instances, the declaration of dividends may be in the best interests of the corporation, notwithstanding the complications caused by COVID-19. In all cases, collaboration, cooperation and open dialogue between LDCs, shareholders and other stakeholders will be essential to properly balance shareholder expectations with the exigencies of other stakeholders in the current challenging circumstances.

[1] *Business Corporations Act*, R.S.O. 1990, c. B.16, s.38(3)

[2] *Business Corporations Act*, R.S.O. 1990, c. B.16, s.134(1)(a)

[3] *BCE Inc. v. 1976 Debentureholders*, (2008) 3 SCR 560 at para. 40

[4] *Toronto Hydro v. OEB*(2010) 93 O.R. (3d) 380 (CA)

[5] *Business Corporations Act*, R.S.O. 1990, c. B.16, s.134(1)(b)

Authors

Ron W. Clark
Partner
T 416.865.7701
rclark@airdberlis.com

Stephanie D'Amico
Student-at-Law
T 416.863.1500 x3317
sdamico@airdberlis.com

Sarah Newman
Associate
T 416.865.4720
snewman@airdberlis.com

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