OP-ED CONTRIBUTOR

This Bailout Doesn’t Pay Dividends

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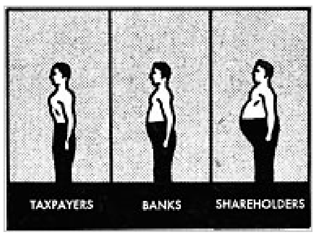

Alain Pilon

ON Oct. 13, the chief executives of nine large American banks were called to a meeting at the Treasury Department. At the meeting, Secretary Henry Paulson offered them $125 billion from the federal government in exchange for shares of preferred stock. The chief executives accepted his terms. In some accounts of the meeting, Secretary Paulson is described as playing the role of the Godfather, making the banks an offer they could not refuse. But in one important respect, he was more Santa Claus than Vito Corleone: the agreement allowed the banks to continue paying dividends to common shareholders.

Although there are many things to like about the government’s plan, the failure to suspend dividends is not one of them. These dividends, if they are paid at current levels, will redirect more than $25 billion of the $125 billion to shareholders in the next year alone. Taxpayers have been told that their money is required because of an urgent need to rebuild bank capital, yet a significant fraction of this money will wind up in shareholders’ pockets — and thus be unavailable to plug the large capital hole on the banks’ balance sheets.

Moreover, given their own equity stakes, the officers and directors of the nine banks will be among the leading beneficiaries of the dividend payout. We estimate that their personal take of the dividends will amount to approximately $250 million in the first year.

Bank executives may argue that it is necessary for them to maintain dividend payments to support their stock prices and to make further capital-raising possible. This argument is dubious. In recent years, the fraction of American public companies that pay dividends has fallen drastically, to a level of around 20 percent. The ranks of the companies that do not pay dividends include some of the most profitable and (until recently) best-performing market darlings, like Google.

These companies have come to recognize what finance academics have been preaching for decades: for financially healthy firms, there is no particular imperative to pay

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dividends every quarter, because retained cash can always be paid out to shareholders later, or used to repurchase stock.

So why would the banks want to maintain large dividend payouts when they’ve had such a hard time borrowing, are starved of cash, and the credit markets believe that they run a significant risk of defaulting? Shouldn’t these distressed banks be marshalling all of the financial resources available to them to ensure their viability?

Although dividends should be a matter of near indifference to shareholders of healthy companies, when companies are financially distressed there is a conflict of interest between shareholders and bondholders that leads shareholders to prefer immediate payouts.

Here’s why: Each dollar paid out as a dividend today is a dollar that cannot be seized by creditors in the event of bankruptcy. For a distressed company, dividends are not in the interest of the enterprise as a whole (shareholders and lenders taken together), but only in the interest of shareholders. They are an attempt by shareholders to beat creditors out the door.

The government should close the door by putting an immediate stop to the dividend payouts of any banks receiving direct federal support. The purpose is not just to be fair or to avoid unsavory appearances, but to improve the health of the banks and the economy.

There is ample precedent for such a move by the government. When Chrysler was bailed out with government loan guarantees in 1979, the legislation explicitly prohibited Chrysler from making any dividend payments. All dividends on its common shares were suspended from 1980 to 1983.

If the government is unwilling to take this step, then the boards of the banks should take it upon themselves to do the right thing. They may even have a legal obligation to do so, because courts have ruled that directors of financially distressed firms have a fiduciary duty to creditors as well as to shareholders.

The creditors of the banks include not just those who have already lent them money, but also American taxpayers who put their money on the line by guaranteeing the banks’ debts. From the perspective of this broader set of stakeholders, it is best to end dividend payments until the banks have returned to health.

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