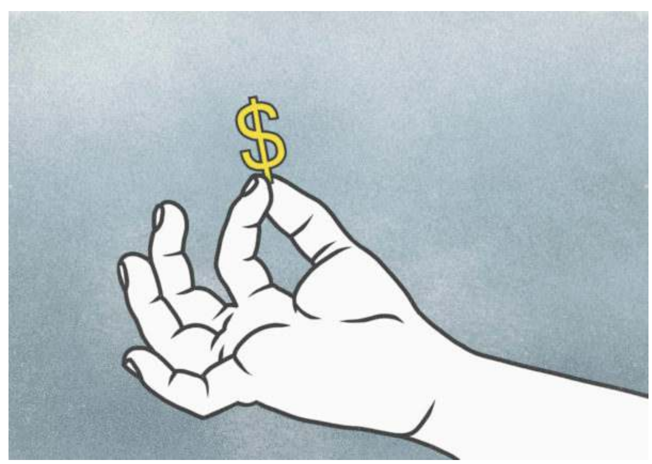
The Importance of Dividend Policies for Family-Owned Businesses

By Frederic L. Smith Jr. on May 30, 2019



In our family business practice, we commonly see conflicts between shareholders who are active in the business and shareholders who are not active in the business. The conflict usually arises from the relatively rich compensation paid to the active shareholders (in the forms of salary, bonuses and other benefits) versus the relatively paltry dividends paid to the inactive shareholders. Of course, what is "rich" and what is "paltry" is often in the eye of the beholder. Without question, though, a lack of investment liquidity is a genuine concern for a family business owner who is not active in the family's business.

It is important for family business owners to recognize that every business has a dividend policy—regardless of whether the directors and shareholders have ever even discussed one. What the company does with excess cash is its dividend policy. Does the company re-invest excess cash to grow the business? Does the company reduce debt or make an acquisition? Does the company repurchase shares? Or does the company pay dividends? If a family-owned business pays above market compensation to family employees, or purchases vehicles and vacation homes for the use of family members who are not active in the business, the company is in reality paying dividends to the family members who receive these payments or other benefits. How the company allocates excess cash flow among the various alternatives makes up its dividend policy.

In some cases, the board or controlling shareholders may make dividend decisions for the wrong reasons. Deferring dividend payments to keep money away from younger generation shareholders, or to avoid making distributions to certain minority shareholders, may lead to family conflicts and potentially legal disputes. Not paying dividends for the purpose of acquiring non-operating assets in the business, or to enable the controlling shareholder to pursue personal projects in the business, may also lead to problems.

There is no rule of thumb for how much a family business should distribute in the form of dividends. However, we find that family business owners who have thoughtful discussions about setting a realistic dividend policy, and who then follow their policy, are less likely to have conflicts. In addition, paying dividends allows family business owners to invest assets outside of the business and diversify their portfolios.

Different family businesses will have different approaches to dividend policies. One approach is for the owners to set the expectation that all shareholders—regardless of whether they are active in the business—are entitled to receive a certain return on their investment each year. The shareholders, acting through the board of directors, can then direct management to operate the business accordingly. This approach tends to focus management's attention on generating sufficient earnings and cash flow to meet the owners' expectations. Outside consultants may be helpful in advising business owners on how to set realistic expectations and policies.

Implementing a dividend policy is a good way to minimize conflicts among business owners—and the key to establishing a well-functioning dividend policy that is open and encourages candid communication among the family business owners.

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