A dividend policy helps to ensure predictability and family harmony

BY CHARLIE CARR

In the early years of a business, when the founding generation needs or wants extra cash, they make a distribution from the business to their personal account (if the company is turning a profit). Over the years, they gift or sell ownership to the second and perhaps third generations, and distributions become more complex.

When siblings and cousins — each with different skills, interests and needs, some working in the business and others not — share ownership, they may argue over how and when distributions should be made. Even if everyone is ultimately content with the amount of money distributed, disputes may arise about their predictability and how the amount is determined. A dividend policy can help the family maintain unity.

A dividend policy is a written statement specifying a philosophy about distributions — their timing and method. The dividend policy usually includes caveats, allowing flexibility when market or business conditions change, or in a year when the board votes to fund additional capital investments in lieu of funding the dividend.

In a family business, a dividend policy is generally not a legal agreement. It does not hold the board or owners to its provisions, but it does provide insight and direction.

Minority owners often tell us that they understand why dividends are not paid in a year when the market is in upheaval or when the business made a major acquisition. However, they often want some indication of what those dividends will look like in normal years. Each shareholder has different needs and interests, and such a policy provides visibility to everyone.

Before describing such policies, let's review what is being paid out. As a business makes profits, there are three ways those profits can be used:

1. To pay incentives to staff (bonuses or profit sharing).

2. To reinvest in the business, perhaps by funding new endeavors, paying down debt or building reserves.

3. To pay distributions to owners or redeem shares from owners.

Most businesses choose a combination of the three options. A stated dividend policy provides direction to owners and the board. In most instances, the policy is not a lengthy document — just a few sentences or perhaps up to a page.

The largest family businesses, likely generations removed from the founders, often mitigate dividend arguments by having trusts as a buffer between the business and family owners. In good years, or perhaps following periodic transactions (e.g., selling a property or business unit), the business makes large distributions into the family trusts. Family members use the trusts for living and other financial needs and become interested in distributions if the trust is running low. This frees the business to reinvest, avoiding an annual discussion.

Dividend philosophy

A dividend policy usually opens by specifying the family's philosophy. This is a general statement that captures their intent. Such statements can be quite diverse. Here are just a few examples:

• *Only those working in the business should benefit from it.* Such a family does not pay dividends, instead focusing on providing bonuses to those in the business and reinvesting in the overall business. Owners not working in the business can realize a benefit only by selling their shares. This may cause challenges when the business is highly profitable and struggles to find new investments for those profits. Note that if this is a flow-through entity (i.e., where the income and taxes are reported on each owner's tax return), the business may still issue a distribution to cover annual tax liability.

• *Those impacting business growth and performance should receive additional benefit.* In this case, the board may provide cash and perhaps extra ownership shares as a bonus to those working in the business, while still paying dividends to all owners.

• *We don't want family members who don't work in the company to live off it.* Such businesses still provide dividends, but perhaps not as large as they might be finan-

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cially capable of. They may find ways to encourage family members to hold a job, whether in the company or outside. The business is stewarding the wealth for future generations.

• *We want to provide a consistent cash flow to owners.* These businesses try to provide a predictable and constant dividend stream, perhaps not as large or as small as the net income suggests, in order to ensure dividends can be paid in both good years and bad.

THE MORE THE FAMILY UNDERSTANDS THE BUSINESS REQUIREMENTS AND PHILOSOPHY, THE MORE LIKELY YOU ARE TO HAVE UNITY AND AGREEMENT.

Defining a dividend philosophy is a great activity for a family meeting. Talk through the goals and interests of various owners and see if you can create a philosophy in one or two sentences. The more the family understands the business requirements and philosophy, the more likely you are to have unity and agreement. The process of defining this philosophy can be as important as the resulting statement.

Dividend timing

The policy should address when dividends will be paid. Will they be paid quarterly, as many public corporations pay dividends; annually, as many private businesses do; or every few years based on business performance? If dividends are paid annually, will they be paid at the end of the year, based on projected financials for the year, or sometime in the first quarter of the following year, after the full year financials are known —or will that amount be broken into quarterly payments for the next year?

Dividend methods

Family businesses provide dividends in a variety of ways. We often see businesses define a fixed base payment — some amount that can be sustained in good and bad years — plus a variable component to boost payments in good years. Here are some of the most common:

• No dividends. Only owners who work in the company see a benefit from that ownership. Other owners see the growing balance sheet but need to sell shares in order to receive a benefit.

• Dividends only following key transactions. The business may go years between payments, although those payments may be quite large following liquidity events.

• Which way is the wind blowing? The board or controlling owners choose an amount based on a review of the business's performance, their own personal needs and the industry. Such distributions are not predictable or consistent.

• Constant amount. Dividends are the same amount each year, regardless of the business's growth or performance.

• Specified percentage of net income or cash flow.

• Tax distributions (for flow-through entities). An amount is distributed based on the most common tax rate. Some companies base distributions on the highest tax rate within the ownership group

• Percentage of the value of the business, as an attempt at providing a yield on investment.

• Distribution based on a different metric. For example, families may pay out the rent received on a specific income-producing property (even when that property is unrelated to the rest of the business), or distribute rent on land owned, as though that land were rented out to a third party.

The last method specified, distribution based on a different metric, is sometimes used as a base amount. The business might own an office building near its manufacturing plant and rent that building to unrelated parties. The net income on that building is paid as a dividend to owners, on the premise that even in a bad year, that amount can go out to owners. In good years, owners may receive a portion of the net income from the main business as well.

As you define your dividend policy, it may be valuable to compare that policy to the market. How will the income stream compare to what your competitors in the industry are paying, as well as to an investment in the stock market? It's easy to find out what your public competitors are doing; you'll likely have to rely on networking and relationships to learn the policies and payouts for privately held competitors. You shouldn't let a competitor prod you to pay more than the business can sustain, but such a comparison can serve as a benchmark for the family.

There can be great value to being part of a family business, both financially as well as relationship-wise. Thinking through and developing a dividend policy can reduce the friction in the family while providing value to each owner. FB

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