Burges Salmon

Dividend policies: an introduction

Must a company pay a dividend?

Unless specifically required to do so by its articles or by a shareholders' agreement, a company is under no obligation pay a dividend. Legally, a company cannot pay any dividend unless it has sufficient distributable reserves. Even where the company does have sufficient distributable reserves, it is up to the directors to assess what is, in their commercial judgement, appropriate having a view to the company's ongoing financial requirements.

Although there is no requirement to pay a dividend, in many family businesses there will be shareholders who depend on dividend income and it will be important to try to meet their expectations or at least alert them where there is an anticipated shortfall. Financial issues can be divisive within any family and failure to pay dividends as expected can cause real difficulty.

Do we need a dividend policy?

Whether a company has a dividend policy is a matter of choice. For a first or second generation family business with few shareholders a dividend policy may not be needed because communications will be easier and it is likely that shareholders will be more closely involved in the decision of whether or not to pay a dividend. However, in an older family business, where there are more shareholders and where the day to day management of the business may no longer rest with the family, having an agreed policy on dividends can be essential.

How does a dividend policy help?

Dividend policies aim to provide clarity to all stakeholders and to reflect the family's 'vision' for the future of the business. In particular they aim to set expectations between the shareholders themselves and also between the board and the shareholders.

Clarity for shareholders

There is potential for friction between the shareholders who work in the business and those who don't. This can occur because those who don't work in the business may feel that dividends will be reduced if family members working in the business are over-rewarded. A dividend policy (which may be closely linked with a remuneration policy) helps to address this by setting out expectations in advance. A fair and transparent policy can be an important factor in helping to head off potential dispute in the future.

Clarity for the board

As already noted, the decision to recommend a dividend is taken by the board, having regard to the anticipated financial needs of the business. Instinctively, the board may want to be prudent and to prioritise reinvestment whereas shareholders may seek a better financial return. A dividend policy helps to give clarity to the board on the amount to be distributed to shareholders and therefore the profit which is available to be reinvested. This will help to guide the board's decision-making.

What does a dividend policy look like?

The way in which a dividend policy is recorded will differ. For smaller family businesses it may be set out in a shareholders agreement, whereas for a larger family business it is more likely to be set out in a family constitution/charter.

The starting point in preparing the policy is to understand the needs and expectations of the shareholders and the family's vision for the business (eg reinvestment to achieve rapid growth vs increased return to shareholders). In a smaller business, greater flexibility can be achieved by creating different classes of shares with different dividend rights, which enable dividends to be directed to certain family members at different times (eg to retired family members or to parents to help meet education costs). However in larger families a simple share structure is more likely to be appropriate because it affords greater transparency.

Any dividend policy will need to set out the amount of dividend which is expected to be paid. This could, for example, be by reference to a percentage of the value of the company's net assets, or a percentage of annual profit. Shareholders may be entitled to ask the board for dividends up an agreed limit annually and the board may require advance warning before the target can be increased. In addition the policy could include a requirement to calculate payments by reference to average profits over, say, the previous three years to ensure that there is a 'smoothing' effect and that payment in any year is not particularly low or high due to one off factors.

Summary

A dividend policy is an important tool to help provide clarity to all stakeholders. When drafting a dividend policy it is important that the policy should be realistic, agreed by everyone and reviewed regularly. Where dividend targets are unlikely to be met it will be important to communicate this in good time with all shareholders.

For more information please contact:

Jim Aveline / Partner
Private Wealth

T +44 (0) 117 939 2283
E jim.aveline@burges-salmon.com

Douglas Streatfeild-James / Senior Associate
Corporate

T +44 (0) 117 902 6341
E douglas.streatfeild-james@burges-salmon.com

www.burges-salmon.com

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