7 February 2012

The Manager
Corporate Reporting and Accountability Unit
Corporations and Capital Market Division
The Treasury
Langton Crescent
Parkes ACT 2600
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Dear Sir or Madam,

Proposed Amendments to the Corporations Act

I have pleasure in enclosing a submission in response to the Treasury's Discussion Paper – Proposed Amendments to the Corporations Act released in November 2011.

The submission has been prepared by the Corporations Committee of the Business Law Section of the Law Council of Australia.

Thank you granting the Committee an extension of time in which to lodge this submission.

Yours faithfully,

Margery Nicoll

Margery Nicoll
Acting Secretary-General

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Proposed amendments to section 254T of the Corporations Act

To the Treasury

By the Corporations Committee

Business Law Section

Law Council of Australia ("Committee")

Dated: 7 February 2012

Table of Contents

Our submission 3
Executive Summary 3
The crux of the problem 3
History 4
Policy rationales 5
Ambiguous aspects of the new section 254T 6
The scope of “assets and liabilities” 6
Fair and reasonable to the company’s shareholders as a whole 7
Interaction with Part 2J of the Corporations Act 8
Practical implications of the new section 254T 8
Conclusion 9
Tax issues 9
Conclusions 10

The Committee welcomes the opportunity to comment on this paper and is grateful for the amount of time granted in which to respond.

Our submission

Executive Summary

We strongly support Option Two, as outlined in the Discussion Paper: Adopting a solvency test. To that end, we have drafted possible wording that might be considered by Treasury, taking into account the existing concerns with section 254T.

While we would not support any of the other options proposed, we would ask that in the event Option Two were not adopted, that the changes suggested in the Committee's letter to David Bradbury on 1 November 2010 be considered and adopted in the alternative.

The crux of the problem

As outlined in the submission to Treasury dated 17 June 2010, whilst the adoption of a solvency test to replace the previous requirement that dividends only be paid out of profits was supported, what was actually proposed in the draft was the adoption of a balance sheet test rather than a cash flow test, in conjunction with a "fair and reasonable to shareholders" and "no material prejudice to shareholders" tests, as used in Chapter 2J of the Corporations Act 2001 (Cwlth) ("**Corporations Act**") in the context of capital reductions.

In December 2002, a discussion paper of the Legislation Review Board of the Australian Accounting Research Foundation was released that supported the adoption of a solvency test for payments of dividends, as opposed to the profits test. It set out that comparative jurisdictions were Canada and New Zealand, both countries which have solvency tests that are coupled with a balance sheet test (see comparative table attached); the balance sheet test enabling dividends to be paid out of capital.[1] We supported the reasoning provided in that paper for the adoption of a solvency test, based on those jurisdictions.

We support reform of the new section 254T for the reasons outlined in the Discussion Paper, particularly in respect of the use of the burden on companies in respect of accounting standards-based calculations to determine whether assets exceed liabilities, the use of the word "declared" and the franking issues surrounding dividends.

Further, we agree with all the benefits outlined in the Discussion Paper as to why Option Two should be adopted. We disagree however with the disadvantage raised, that is, that the section would be somehow deficient without an express link to accounting standards. We do not agree that without a link to the standards there would be a subsequent loss in objectivity or consistency in determining a company's ability to pay a dividend. Moreover, while Option Two will provide directors with the

[1] Additionally, we note also that Delaware and New York State, for example, also have balance sheet tests.

flexibility to decide what values it can adopt for the purpose of determining a company's ability to pay a dividend without reference to accounting standards, such flexibility is not unfettered since the directors remain subject to their general duties in exercising such discretion.

On a practical level, the new section affects the practice of "determining" dividends, exposes directors to more liability risk due to the solvency requirement and affects certain project structuring.

Further, given ASIC does not have the power to grant relief from, or to otherwise modify, section 254T, some companies will be left hamstrung until the reforms are made. Examples of companies in this situation may be those with significant intangible assets that are recorded at cost and cannot be revalued, such as infrastructure companies. Such companies will currently need to consider adopting fair value accounting to enable the payment of dividends (if they currently use a historical cost method of valuing assets) or they may need to consider alternative means of distributing cash to shareholders in these circumstances (eg. a share buy-back or return of capital).

History

Prior to July 1998, section 201(1) of the Corporations Law stated:

No dividend shall be payable to a shareholder of the company except out of profits or under section 191.

Section 201(1) of the Corporations Law was replaced with section 254T by the Company Law Review Act 1998 (Cwlth). From 1 July 1998 to 27 June 2010, section 254T of the Corporations Law / Corporations Act stated:

> *A dividend may only be paid out of the profits of the company.*

That is, section 254T of the Corporations Act only permitted a dividend to be paid out of company profits ("**Profits Test**"). The Explanatory Memorandum to the Company Law Review Act explained the reason for the change as follows:

> *11.39 Currently, dividends to shareholders can only be paid out of profits or by issuing shares from the share premium account (current s201(1)). Where a dividend is to be paid out of profits, the profits must exist at the time the dividend is declared: Marra Developments Ltd v B W Rofe Pty Ltd (1977) 2 NSWLR 616…*
>
> *11.40 The Bill will allow companies to avoid the problems that would arise if profits that would have been sufficient to cover the dividend was declared have ceased to exist when the time comes to pay the dividend. Under the Bill, a debt will not arise until the time fixed for payment has arrived, unless the company has a constitution that provides for the declaration of a dividend. Directors will be able to revoke a decision to pay a dividend at any time before the time fixed for payment, and thus avoid a debt being incurred (Bill s 254V).*
> *…*
>
> *11.43 By providing that dividends must be paid out of profits (Bill s 254T), the Bill will require that profits exist at the time fixed for payment of the dividend.*

However, concerns were raised with the Profits Test:

the term "profits" was not defined in the Corporations Act;

*the nature of accounting principles for calculating profits has changed over time (particularly as a result of the adoption of the International Financial Reporting Standards ("**IFRS**")), such that there have been significant movement in income statements that affect profit, but have no impact on the liquidity or ongoing operations of the company; and*

it was inconsistent with the trend to lessen the Australian capital maintenance doctrine.

Accordingly, the law was amended by the Corporations Amendment (Corporate Reporting Reform) Act 2010 (Cwlth) ("Reform Act") to permit a company to pay a dividend if:

a) its assets exceed its liabilities immediately before the dividend is declared and the excess is sufficient for the payment of the dividend;

b) it is fair and reasonable to the company's shareholders as a whole; and

c) it does not materially prejudice the company's ability to pay its creditors.

The objective of the new test as to when a company may pay a dividend is stated to be to ensure that companies have the ability to distribute dividends if they can do so without causing detriment to ongoing operations. It is stated that the first limb of the new test is similar to the balance sheet test currently in operation in New Zealand and Canada. The second and third limbs align the new test with the requirements imposed on companies in relation to conducting share capital reductions and buy-backs under Part 2J of the Corporations Act - see below.

There is a critical distinction between the Australian test, as adopted, and the tests present in New Zealand and Canada. As can be seen in the attached table, those jurisdictions refer to "the realizable value" of the Corporation's assets or the "value of the company's assets", rather than the vagaries of accounting principles.

Notwithstanding the new test, it cannot be said that Australia has moved sufficiently away from the Profits Test so that the objective stated above can be achieved. In the legal opinion obtained by the Commissioner of Taxation in connection with the preparation of draft Taxation Ruling TR 2011/D8[2] ("**Legal Opinion**") it is argued that "the requirement that there be a profit to be divided in dividends remains".

Policy rationales

The main policy driver given for the change to the dividend rules is the need for such rules to be aligned with current accounting principles after Australia adopted the IFRS. The Explanatory Memorandum to the Reform Act ("**Explanatory Memorandum**") notes that Australian accounting standards are increasingly linked to fair value (whether realised or unrealised), which may impact on the profitability of the company. This means that whilst a company may have sufficient cash to pay a dividend to shareholders, it is unable to do so, as the accounting profits of the company have been eliminated by non-cash expenses.[3]

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[2] Slater, A. H. and Hmelnitsky, J. O., ''Corporations Amendment (Corporate Reporting) Reform Act 2010: Payment and franking of dividends – Joint opinion", 29 November 2011.

[3] Many attribute the reform to dividend rules to the growing irrelevance of the capital maintenance doctrine. That doctrine, first articulated in *Trevor v Whitworth,* requires that a company must maintain its initial capital base together with

It is argued that the capital maintenance doctrine is outdated, as evidenced by the abolition of both "par value" shares and the need for court approval for capital reductions. The solvency test was introduced into Chapter 2J of the Corporations Law as a result of the Second Corporate Law Simplification Bill.[4] At that stage, there was no commentary which specifically outlined the reasoning behind the move to the solvency test. The introduction of a solvency-based test for paying dividends is consistent with the trend of departing from the capital maintenance doctrine, and is also in line with the reforms in common law jurisdictions such as New Zealand and Canada (see table attached).

A number of commentators[5] have expressed scepticism as to the effectiveness of the capital maintenance doctrine in protecting creditors. This is because the pool of funds to which creditors have recourse (the share capital of the company) is less than the total retained earnings, bank overdraft, debentures and other unsecured notes of the company. They also argue that the primary source of credit protection under the legislation will be the deterrent effect of personal director liability for allowing the company to trade whilst insolvent under section 588 of the Corporations Act.

While not expressly stated as a policy driver in the Explanatory Memorandum, the change to the dividend rules appears to be a response to the view that a solvency test would better protect creditors than the capital maintenance doctrine.

Ambiguous aspects of the new section 254T

There are a number of ambiguities created by the adoption of the new section 254T. In our view, those ambiguities are unsatisfactory and support the adoption of a new approach. Set out below is a catalogue of the more significant of those ambiguities. Any reform should deal with these ambiguities.

The scope of "assets and liabilities"

Many have argued that section 254T should define what constitutes the "assets and liabilities" of the company, particularly on the question of whether contingent liabilities are to be included.

To seek some clarification, it may be possible to have regard to judicial interpretations of the solvency test in section 95A of the Corporations Act:

> "*a person is solvent if, and only if, the person is able to pay all the person's debts, as and when they become due and payable.*"[6]

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any subsequent capital raisings. It was introduced as a response to concerns of creditors following the development of limited liability companies, whereby creditors would have no recourse to the shareholders in the winding up of the company.

4 See the Exposure Draft, Volume 2, June 1995.

5 For example, Factor, L. *Capital Maintenance: Simplification and Creditor Protection* (1995) 5 Australian Journal of Corporations Law 259; Armour, J. *Legal Capital: An Outdated Concept?* Euro Business Organisation Law Review (2006) 7:1:5-27

6 *Box Valley Pty Ltd v Kidd* (2006) 24 ACLC is the most recent authority on whether contingent liabilities constitute a "debt" and should therefore be included in determining whether a company is solvent. This is a case on whether directors breached insolvent trading prohibition under section 588G of the Corporations Act, when it entered into forward purchase agreements under which no recognisable debt or ascertainable amount was payable.

The court importantly distinguished between contingent liability to pay an unliquidated sum and contingent liability to pay a liquidated sum. Only the latter constitutes "debt" for the purposes of section 95A of the Corporations Act. In its reasoning, it distinguished *Hawkins v Bank of China* (1992) 26 NSWLR 562 which held that a contingent liability could be included as debt on the basis that:

> "*the guarantee executed by the company in Hawkins subjected it to a conditional but unavoidable obligation to pay a sum of money at a future time. The contingent liability incurred by the company in executing the guarantee was*

Accordingly, it is unlikely that contingent liabilities for unliquidated sums will be included when determining whether the company's assets exceed its liabilities for the purposes of the new dividend rules.

Fair and reasonable to the company's shareholders as a whole

The requirement that the payment of the dividend must be "fair and reasonable to the company's shareholders as a whole" raises two questions.

The first question is whether the requirement restricts directors from issuing shares with preferential dividend rights. Under section 54W(1) of the Corporations Act, each share in a class of shares in a public company has the same dividend rights unless the constitution provides otherwise or the company passes a special resolution approving otherwise. Under section 254W(2) of the Corporations Act, which is a replaceable rule, the directors may pay dividends as they see fit, subject to the terms of issue of the shares. Therefore, there is a question as to whether directors of public companies can issue shares with preferential dividend rights even if their constitution enables them to do so, and also whether directors of proprietary companies can issue shares with preferential dividend rights as they "see fit".

The second question is a more general one about what constitutes "fair and reasonable to shareholders as a whole". An understanding of the content of this requirement may assist in answering the first question. The Explanatory Memorandum to the Company Law Review Act 1997 (Cwlth), which introduced the "fair and reasonable to shareholders as a whole" test in share capital reductions, may offer guidance. Paragraph 12.24 of that Explanatory Memorandum states that the test should be viewed as a "composite requirement" and the factors to be considered include:

a) the adequacy of consideration; and

b) whether some shareholders are deprived of their rights (for example, by stripping the company of funds that would otherwise be available for distribution to preferential shareholders).[7]

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thus for a liquidated amount rather than damages for breach of contract … in the present case the exposure of David Kidd Grain Trading Pty Ltd under its futures trading in white cottonseed did not give rise to a contingent liability to pay a liquidated sum. The exposure consisted of insufficient forward purchase contracts to meet forward sales obligations … thus the prospect that the company would sustain a loss in the future on its dealings in white cottonseed, did not, in my view, constitute a debt for the purposes of the Corporations Act 2001 (Cth), s95A when the company's solvency or insolvency had to be considered." (per Gzell J).

New Cap Reinsurance Corporation Ltd (in liq) and Another v AE Grant & Others [2008] NSWSC 1015 affirmed this principle, and held that a company's liabilities to indemnify reinsureds could be taken into account as contingent debts provided that it is for a liquidated amount. The Supreme Court of NSW suggested that the following principles are relevant when determining the question of solvency under section 95A: "*it is legitimate to use hindsight;*

(a) although the words "as an when they become due and payable" require looking into the future, usually only the reasonably immediate future, the inquiry depends on the type of case with which the court is concerned; and

(b) contingent or prospective debts should be taken into account."

[7] Some specific case examples are *Re George Raymond Pty Ltd*, which held that adverse taxation consequences for some shareholders does not constitute unfairness or unreasonableness. *Winpar Holdings Limited v Goldfields Kalgoorlie Ltd* (2002) 20 ACLC 265 held that the pro rata distribution of head office cost cuts to both departing shareholders and remaining shareholders was not "unfair and unreasonable". This is even though it meant that the value of the shares of remaining shareholders was higher than the value of shares of the departing shareholders whose shares were being cancelled. The court reasoned that:

"*if the special benefits are of such unique value that they should lead to the minority shareholders receiving more than a pro rata proportion, it may be that it would be fair and reasonable for a greater than pro rata proportion of that special value to be attributed to the shares of the minority. However, there is nothing in the facts before me which indicates that any special value is other than the normal advantages of having a wholly owned subsidiary as*

Interaction with Part 2J of the Corporations Act

There is substantial doubt as to whether the new section 254T permits an authorised reduction of share capital without satisfying the requirements of Part 2J of the Corporations Act, particularly the requirement to obtain shareholder approval. This is because an ambiguity arises since, although the Explanatory Memorandum suggests that the new provision is to operate as an exception to the maintenance of capital rules, the provision is drafted as a prohibition on payment of a dividend unless the three tests are met.

There are divergent views on this issue. For example, in the Legal Opinion it is argued that a reduction of capital must still comply with the statutory procedure and protections.

Companies and their advisers should not be put in the position of having to take a view on this important issue (with potentially serious consequences if they are wrong) when it can be easily clarified by inserting a note into the section clarifying the inter-relationship between the operation of the dividends test and the capital maintenance provisions. Accordingly, we have built notes in to the proposed re-draft of the section, outlined below.

Practical implications of the new section 254T

In addition to legal ambiguities about how section 254T should apply, there are also practical implications of the reform such as additional costs for small proprietary companies which may need to engage accountants to determine their assets and liabilities.

One issue is the use of the word "declared" in the requirement "the assets and must exceed its liabilities immediately before the dividend is declared", as outlined above. As a practical matter, companies generally "determine" dividends, because a declaration of a dividend becomes a debt owing to the shareholders at the time it is declared rather than the payment date (see section 254V(2) Corporations Act). Indeed, some companies do not have a power in the constitution to allow directors to declare a dividend.[8]

Furthermore, although the potential for personal director's liability for insolvent trading may afford creditors protection, the requirement for solvency confirmation may deter directors from paying dividends.

The test also affects how projects may be structured. Previously, projects involving substantial upfront capital investment were structured as trusts, in order to facilitate the distribution of cash flow where there would be no profit as a result of large non-cash deductions arising from depreciation. The change from a profits based test to a

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against partial ownership ... the advantage is an advantage to the acquiring majority, but it is also an advantage to the acquired minority in that, on acquisition, they obtain an enhanced price for their shares. There is no necessary unfairness or unreasonableness if the advantage is shared."

It can be seen from both the *Re George Raymond Pty Ltd* and *Winpar Holdings Limited* decisions that "fairness and reasonableness" does not require equal treatment of shareholders. Rather, the focus was on whether the capital reduction reduced any rights attached to a particular class of shares. Unless the terms of issue state otherwise, ordinary shareholders generally do not have rights to a dividend. As such, an issue of shares with preferential dividend rights arguably do not deprive such shareholders of their "rights". Therefore, the "fair and reasonable to shareholders as a whole" requirement arguably does not restrict directors from issuing shares with such preferential rights.

[8] Austin, Robert, "The new dividend law is a failure" *The Australian Financial Review*, Monday 6 September 2010.

solvency test (which includes a net asset test) may mean that such corporate structures are less attractive for these projects.

Conclusion

For the reasons set out above, we support the replacement of section 254T with a simple solvency test. The Committee has drafted a proposed provision that would achieve that objective:

> A company may pay a dividend on its share capital.[1] [2]
>
> [1] Subject to the solvency test (see section 95A).
>
> [2] A dividend which involves a reduction in capital is authorised by law.

Tax issues

For income tax purposes, a dividend is defined to mean, broadly, any distribution made by a company to its shareholders, other than an amount that is debited against the company's share capital account. Therefore, distributions made as a result of the amended section 254T of the Corporations Act will generally be dividends for income tax purposes.

At the time that section 254T was amended, section 44(1A) of the Income Tax Assessment Act 1936 (Cwlth) was introduced to ensure that corporate distributions that are dividends for the purpose of the Corporations Act and for income tax purposes will also be taken to be 'paid out of profits' for income tax purposes. This ensures that shareholders include these distributions in their assessable income even though they may not be paid by the company out of profits.

The Explanatory Memorandum also provided that, subject to the operation of the dividend imputation integrity rules, such distributions will be frankable. When the Corporations Act was amended in 2010 to allow dividends to be paid in circumstances where a company's assets exceed its liabilities, it was expected that there would be no significant change to the circumstances in which dividends could be franked for income tax purposes. In particular, it was expected that dividends that could be franked prior to the amendments to section 254T could continue to be franked after those changes – but, as highlighted below, this does not mean that all dividends paid after the amendments to section 254T will be frankable.

The Australian Taxation Office ("**ATO**") has recently issued a draft Taxation Ruling about the taxation of dividends paid in compliance with section 254T from 28 June 2010 ("**Draft Ruling**"). The Draft Ruling sets out the ATO's views on the assessment and franking of dividends in three broad cases, whilst noting that the proper treatment of a dividend payment for taxation assessment and franking purposes is, in each case, a question of the application of the Corporations Act and the Taxation Acts to the facts and circumstances of the particular payment.

The adoption of our submission does not conflict with the approach adopted by the ATO.

In the Draft Ruling, the ATO states that:

- A company that pays a dividend to its shareholders (i) in accordance with its constitution and without breaching section 254T or Part 2J.1 of the Corporations Act and (ii) out of current trading profits recognised in its accounts and available for distribution, is not prevented by section 202-45(e) of the *Income Tax Assessment Act 1997* from franking the dividend merely because the company's net assets are of a value less than its share capital or the company has unrecouped prior year accounting losses. That dividend will be assessable income of its resident shareholders;

- A company that pays a dividend to its shareholders (i) in accordance with its constitution and without breaching section 254T or Part 2J.1 of the Corporations Act and (ii) out of an unrealised capital profit of a permanent character recognised in its accounts and available for distribution, is not prevented by section 202-45(e) from franking the dividend *provided* the company's net assets exceed its share capital by at least the amount of the dividend. That dividend will be assessable income of its resident shareholders; and

- A distribution (even if it is labelled as a dividend) paid by a company to its shareholders that does not comply with section 254T or Part 2J.1 of the Corporations Act, is an unauthorised reduction and return of share capital that, depending on the particular facts and circumstances of the payment (i) will be taxed as a CGT event under the capital gains tax provisions, or (ii) will be taxed as an assessable unfranked dividend.

Conclusions

The Law Council supports the proposed Option Two amendment outlined in the Discussion Paper, for the reasons outlined above. Should this reform not be accepted, the Committee would ask that Treasury consider the alternative amendments to the law outlined in the letter to David Bradbury dated 1 November 2010 (attached.)

Legislation	Australia	Hong Kong	United Kingdom	New Zealand	Delaware	United States (operational in 24 States)	Canada
	Corporations Act 2001 s254T	*Companies Ordinance 1991* Part IIA s79B, Sch 1, s117	*Companies Act 2006*, Part 23 ss 830, 831	*Companies Act 1993* ss 4, 52	*General Corporation Law 1953* §170	*Model Business Corporation Act 2005*, §6.40	*Canada Business Corporations Act, 1985, s42*
Actual section wording	s254T: (1) A company **must not** pay a dividend **unless** (a) the company's **assets exceed its liabilities** immediately before the dividend is declared and the excess is sufficient for the payment of the dividend; and (b) the payment of the dividend is fair and reasonable to the company's shareholders as a whole; and (c) the payment of the dividend foes	Part IIA, s79B: (1) A company shall not make a distribution except out of profits available for the purpose. (2) A company's profits available for distribution are its accumulated, **realised profits**, so far as not previously utilised by distribution or capitalisation, less its **accumulated**, realised losses, so far as not previously written off in a reduction or reorganisation of capital duly made.	s830(1) A company (public or private) may only mark a distribution **out of profits** available for the purpose. (2) A company's profits available for distribution are its accumulated, **realised profits**, so far as not previously utilised by distribution or capitalisation, less its **accumulated**, realised losses, so far as not previously written off in a reduction or reorganisation of capital duly made.	s52(1) The board of a company that is satisfied on reasonable grounds that the company will, **immediately after the distribution**, satisfy the **solvency test** may, subject to section 53 of this Act and the constitution of the company, authorise a distribution by the company at a time, and of an amount, and to any shareholders it thinks fit.	s170 (a) The directors subject to any restrictions contained in its certificate of incorporation, **may declare and pay** dividends upon the shares of its capital stock either: (1) **out of its surplus**, as defined in §§ 154 and 244, or (2) if no such surplus, out of its **net profits** for the fiscal year in which the dividend is declared and/or the preceding fiscal	(c) No distribution may be made if, **after giving it effect:** (1) the corporation **would not be able to pay its debts as they become due** in the usual course of business; or (2) the corporation's **total assets would be less than the sum of its total liabilities plus** (unless the articles of incorporation permit otherwise) the amount that would be needed, if the corporation were to be dissolved at the time of distribution, to satisfy the	42. A corporation shall **not declare or pay a dividend** if there are reasonable grounds for believing that: (a) the corporation is, or would **after the payment** be, **unable to pay its liabilities as they become due**; **or** (b) the **realizable value** of the corporation's assets would thereby be less than the aggregate of its liabilities and stated capital of all classes.

Legislation	Australia *Corporations Act 2001* s254T	Hong Kong *Companies Ordinance 1991* Part IIA s79B, Sch 1, s117	United Kingdom *Companies Act 2006*, Part 23 ss 830, 831	New Zealand *Companies Act 1993* ss 4, 52	Delaware *General Corporation Law 1953* §170	United States (operational in 24 States) *Model Business Corporation Act 2005*, §6.40	Canada *Canada Business Corporations Act, 1985, s42*
	not materially prejudice the company's ability to pay its creditors.				year.	preferential rights upon dissolution of shareholders whose preferential rights are superior to those receiving the distribution.	

Legislation	Australia	Hong Kong	United Kingdom	New Zealand	Delaware	United States (operational in 24 States)	Canada
	Corporations Act 2001 s254T	*Companies Ordinance 1991* Part IIA s79B, Sch 1, s117	*Companies Act 2006*, Part 23 ss 830, 831	*Companies Act 1993* ss 4, 52	*General Corporation Law 1953* §170	*Model Business Corporation Act 2005,* §6.40	*Canada Business Corporations Act, 1985, s42*
Test	Balance sheet test, with solvency considerations in parts (b) and (c).	Profits test: Prohibits distribution except out of profits available for the purpose - same as s830 *Companies Act 2006* UK. The test is based on the distribution pool available for paying a dividend, rather than on setting preconditions as to when a dividend can be paid.	Statutory profits test must be satisfied in addition to common law rules that dividends must not be paid out of capital and directors must have regard to company's best interests. The test is based on the distribution pool available for paying dividends, rather than setting preconditions as to when a dividend can be paid.	s4: a company satisfies the solvency test if: (a) the company **is able to pay its debts as they become due**; and (b) the value of the **company's assets is greater than the value of its liabilities**, including contingent liabilities. *s254T(a) adopts the NZ subsection (b) balance sheet test.*	Profits test.	Dual solvency and balance sheet test, sometimes called the equity insolvency test.	Dual solvency and balance sheet test.
History of the provision and Act	Reflects changes in accounting principles, a perceived trend to lessen the capital maintenance doctrine, and	Part IIA, ss79A, 79B copies the UK *Companies Act* 1985. The 1997 Review of	Introduced as s263(1)(3), s264 *Companies Act* 1985. No change to this section by *Companies Act* 2006.	Introduced in the 1990 Act, this test emulates the two-pronged solvency test in s6.40(d) of the US MBCA and s42 of Canada's Business	Introduced by 8 Del. C. 1953. No significant amendments have	The MBCA was produced by the American Bar Association. In 1980 the statutory standards governing distribution were	Emulates the two-pronged solvency test in s6.40(d) of MBCA, the basis for CBCA's reform.

	ensures creditors and shareholders not entitled to dividends sufficiently protected. Adopts parts of the dual tests in New Zealand/Canada.	the Hong Kong Companies Ordinances Consultancy Report recommended adopting the two-pronged solvency test found in s6.40(d) of the MBCA and emulated in NZ but this was not taken up.	The old NZ solvency test contained similar wording, until the NZ reforms took their lead from the North American approach and the MBCA.	Corporation Act (CBCA). "Realisable value" of assets, found in (b) of the CBCA but not the MBCA, was removed from the 1993 Act.	been made to s170 since that time.	revised, removing concepts of "par value" and "stated capital" but retaining the equity insolvency test.	The Dickerson Report's, draft legislation and commentary, was adopted virtually unchanged as the CBCA Previously, the Corporation Act had not been overhauled since 1934.
Legislation	**Australia** *Corporations Act 2001* s254T	**Hong Kong** *Companies Ordinance 1991* Part IIA s79B, Sch 1,s117.	**United Kingdom** *Companies Act 2006*, Part 23 ss 830,831	**New Zealand** *Companies Act 1993* ss 4, 52,	**Delaware** *General Corporation Law 1953* § 170	**United States (operational in 24 States)** *Model Business Corporation Act 2005*, §6.40	**Canada** *Canada Business Corporations Act, 1985, s42*
Criticisms	Lack of clarity on how to value assets and estimate liabilities. Time lag between financial reports and when director's 'declare' dividends.	Capital maintenance and dividend rules, upon which the Ordinance is based, is extremely detailed and complex. Affords little protection to private companies and nor to creditors.	Companies with past losses, whether realised or (for public companies) unrealised, may be unable to pay dividends (especially with the practice of writing off goodwill). Reduce profits / distributable reserves in many cases,			Criticised for pursuing flexibility and modernization too aggressively, at the expense of shareholder protection. Directors have been given much more latitude in declaration of dividends - the overall judgment	

	Difference between 'determine' and 'declare'; declare used in broader sense. May require companies to amend constitutions in order to comply. Lack of clarity on whether share capital can be distributed as a dividend without shareholder approval (as an exception to the capital maintenance rules).		particularly because of accountings changes in relation to retirement benefits and deferred tax. For public companies - mixed use of terms 'net assets' and chare capital and reserves' makes it unclear what s831 adds to s830. It appears possible to 'artificially' convert an unrealised profit into a realised one eg. via intra-group transactions.			required in evaluating the equity insolvency test means there is no one or more "bright line" tests. Certain judgments and assumptions as to the course of the business are customarily justified.	
Legislation	**Australia** *Corporations Act 2001* s254T	**Hong Kong** *Companies Ordinance 1991* Part IIA s79B, Sch 1,s117.	**United Kingdom** *Companies Act 2006*, Part 23 ss 830,831	**New Zealand** *Companies Act 1993* ss 4, 52,	**Delaware** *General Corporation Law 1953* § 170	**United States (operational in 24 States)** *Model Business Corporation Act 2005*, §6.40	**Canada** *Canada Business Corporations Act, 1985, s42*

Distribution or dividend?	Dividend "Dividend" is not a defined term in the Act. Section 254T is unclear whether it authorises reductions of share capital. The UK/Hong Kong use of the term "distribution", with specific exclusions for reductions of capital, is perhaps more clearly worded.	Distribution - has the same wide definitions as UK Act with same exclusions for certain reductions of capital, bonus shares, redemption/ purchase of own shares. But s117 also specifies "no dividend shall be paid…" - the Ordinance explicitly covers both.	Distribution - widely defined as "any distribution of a company's assets to its members". Specific exclusions for issue of bonus shares, certain reductions of capital, redemption/purchase or own shares, distribution upon winding up. For public companies, liabilities and undistributable reserves defined at s831 (3) and (4).	Distribution	Dividend	Distribution S1.40(6) means a direct or indirect transfer of money or other property (except own shares) or incurrence of indebtedness by a corporation to or for benefit of its shareholders in respect of any of its shares. A distribution may be in the form of a declaration or payment of a dividend; a purchase, redemption, or other acquisition of shares,a distribution of indebtedness or otherwise. Thus, it includes declaration or payment of dividends and **unlike the UK / HK -** purchase of corporation's own shares, distribution of evidences of indebtedness or promissory notes, and distribution in in/voluntary liq.	Dividend

Legislation	Australia	Hong Kong	United Kingdom	New Zealand	Delaware	United States (operational in 24 States)	Canada
	Corporations Act 2001 s254T	*Companies Ordinance 1991* Part IIA s79B, Sch 1,s117.	*Companies Act 2006*, Part 23 ss 830,831	*Companies Act 1993* ss 4, 52,	*General Corporation Law 1953* § 170	*Model Business Corporation Act 2005*, §6.40	*Canada Business Corporations Act, 1985, s42*
Out of profits?	Can be otherwise than out of profits, if constitution permits. Balance sheet test intended to allow companies to pay dividends that include share capital - an exception to the capital maintenance rule.	Prohibitive - Only out of profits. Profits now defined in s79B(2) - same as UK.	Prohibitive - Only out of profits. The distribution rules also authorise certain transactions (some of which were previously unlawful) provided they are made out of distributable profits (eg. financial assistance / purchase / redemption of company's own shares).	No prohibition - would allow distribution otherwise than out of profits if dual solvency test satisfied.	Only out of surplus/net profits - prohibitive. Corporations cannot declare dividends except out of profits.[9] Capital cannot be impaired by payment of dividend. Such income or return to stockholders can only be legally be paid from current or accumulated profits.[10]	Would appear to allow distribution otherwise that out of profits.	No prohibition - would allow distribution otherwise than out of profits if dual solvency test satisfied.

9 *Penington v Commonwealth Hotel Constr. Corp. 17 Del. Ch 394, 155 A.514 (1931)*
10 *Ibid*

Legislation	Australia *Corporations Act 2001* s254T	Hong Kong *Companies Ordinance 1991* Part IIA s79B, Sch 1,s117.	United Kingdom *Companies Act 2006*, Part 23 ss 830,831	New Zealand *Companies Act 1993* ss 4, 52,	Delaware *General Corporation Law 1953* § 170	United States (operational in 24 States) *Model Business Corporation Act 2005,* §6.40	Canada *Canada Business Corporations Act, 1985, s42*
					But, s170 has the so-called "nimble dividend" provision, allowing dividends to be paid out of profits from the current or preceding year. Also, s160 permits shares to be repurchased or redeemed out of surplus.		
Relationship with accounting standards	s254T(2) Assets and liabilities are to be calculated for the purpose of this section in accordance with **accounting standards in force at the relevant time**.	Adopts UK *Companies Act* 2006 method of treating realised profits in accordance was **principles generally accepted at the time accounts are prepared**.	Test requires assessing when profits are 'realised' rather in accordance with **principles generally accepted at the time accounts are prepared**. Accounting rules now require provisions to	Directors (a) **must** have regard to (i) **most recent financial statements** of the company that comply with s10 of the Financial Reporting Act 1993; and (ii) all other circumstances that	Directors must be given reasonable latitude in ascertaining values (for purposes of revaluing assets in order to pay dividends), and that absent a showing of fraud or bad faith, [the court] would not substitute its	s6.40(d) The board of directors **may** base a determination that a distribution is not prohibited under subsection (c) either on **financial statements prepared on the basis of accounting practices and principles that are**	

Legislation	Australia *Corporations Act 2001* s254T	Hong Kong *Companies Ordinance 1991* Part IIA s79B, Sch 1,s117.	United Kingdom *Companies Act 2006*, Part 23 ss 830,831	New Zealand *Companies Act 1993* ss 4, 52,	Delaware *General Corporation Law 1953* § 170	United States (operational in 24 States) *Model Business Corporation Act 2005*, §6.40	Canada *Canada Business Corporations Act, 1985, s42*
			be made for depreciation of fixed assets, so dividends are restricted accordingly.	the directors know or ought to know affect, or may affect, the value of the companies assets and liabilities, (b) **may rely on valuations** of assets or estimates of liabilities that are **reasonable in the circumstances**. (Adopted from US MBCA). "Must" has been amended from "may" in s4(2)(a), making it more stringent than the 1990 provision.	judgment for that of the directors.[11]	**reasonable in the circumstances** or on a fair valuations or **other method that is reasonable in the circumstances**. Does not utilise particular accounting terminology of a technical nature or specify particular accounting concepts, unlike UK, HK and Delaware, and directors are given a choice of permissible bases upon which to judge the balance sheet test. The use of generally accepted accounting principles is not mandated as it is in s254T(2), NZ, UK and HK.	

11 *Morris v Standard Gas & Electric Co., 31 Del. Ch 20, 63 A.2d 577 (1949)*

Legislation	Australia *Corporations Act 2001* s254T	Hong Kong *Companies Ordinance 1991* Part IIA s79B, Sch 1,s117.	United Kingdom *Companies Act 2006,* Part 23 ss 830,831	New Zealand *Companies Act 1993* ss 4, 52,	Delaware *General Corporation Law 1953* § 170	United States (operational in 24 States) *Model Business Corporation Act 2005,* §6.40	Canada *Canada Business Corporations Act, 1985, s42*
						Allowing use or current value methods to determine amounts available for distribution aims to ensure the most appropriate methods are used for a particular corporation and its circumstances.	
Positive of negative language?	**Negative language** Doesn't stipulate that if conditions are met, dividend is lawful and doesn't expressly authorise reduction of share capital.	**Negative language** A distribution in breach of the provision is unlawful and ultra vires. (Annotated ordinances)	**Positive language**	**Positive language**	**Positive and negative language** Stipulates that dividend not invalid if could have been lawfully paid at the time.	**Negative language**	**Negative language**

1 November 2010

The Hon David Bradbury MP
Parliamentary Secretary to the Treasurer
Parliament House
CANBERRA ACT 2600

Dear Mr Bradbury

Meeting with representatives of the Corporations Committee of the Business Law Section of the Law Council of Australia

Thank you for agreeing to meet with representatives of the Corporations Committee. Those attending from the Corporations Committee will be Guy Alexander (Chair of the Committee), Kathleen Farrell (a member of the Business Law Section Executive), Marie McDonald (Deputy Chair) and Michael Hoyle (Committee Member).

There are 3 issues we would like to touch on in the meeting which we believe are deserving of your attention:

1. **Rules relating to the payment of dividends.** The recent changes to section 254T of the Corporations Act have increased the compliance burden on companies, rather than having what we believe to be the intended de-regulatory effect. Before the change, it was clear that directors can safely pay dividends out of profits as long as the company is solvent. After the change, more tests need to be met to do this, and it is not clear whether they can pay a dividend out of capital, one of the intended effects of the amendment. There are a range of drafting anomalies as well.
2. **Application of the Personal Properties Securities regime to takeovers and schemes.** It is the Committee's view that the PPS regime casts unintended doubt over the ability of an acquirer in a takeover or scheme to confirm that it has clear title to the securities acquired, which is a highly undesirable state of affairs.
3. **Business judgement rule and insolvent trading.** The Committee wishes to affirm its support for changes to insolvent trading rules which would reverse the current incentive to directors to place companies into administration prematurely.

Detail on the first of these 2 issues are as et out below.

Recent changes to the rules relating to payment of dividends

As indicated in my letter dated 7 October 2010, one particular issue which we would like to discuss with you on Monday is the recent change to the provisions of the Corporations Act dealing with the payment of dividends by Australian companies. In short, this change sought to replace the profits test for payment of dividends by Australian companies with three new tests – (i) a balance sheet test; (ii) a requirement that the payment of the dividend is fair and reasonable to the company's shareholders as a whole; and (iii) a requirement that payment of the dividend does not materially prejudice the company's ability to pay its creditors. The insolvent trading provisions also continue

to apply to payment of a dividend (so that directors cannot pay a dividend if it would result in the company not being able to pay its debts as and when they fall due).

As mentioned in our letter to the Minister dated 17 June 2010 (a copy of which was attached to our 7 October letter), there are a number of practical issues with these changes, particularly for small companies. Since the introduction of the provisions, companies large and small have incurred significant costs in trying to deal with these issues, and will continue to do so in future dividend periods. The four main issues that we would like to discuss with you are:

1. It is not clear that the legislation as drafted has achieved its intention of allowing a company to now pay a distribution out of capital (or where there are no retained earnings) without having to comply with the reduction of share capital requirements in Chapter 2J of the Act. There is a difference of opinion on this amongst law firms, but the predominant view seems to be a company still has to comply with Chapter 2J. If this is the case, then in practice the requirement that dividends be paid out of profits remains, because if dividends are paid otherwise than out of profits a company has to comply with another set of tests in Chapter 2J (two of which are the same as the new tests for a dividend). All that has happened then is that three extra tests have been added before a dividend can be paid. The obvious way to fix this is to make it clear in the legislation that a dividend which satisfies the three tests in section 254T and which involves a reduction of capital does not need to comply with Chapter 2J.

2. Under the changes, the balance sheet test is determined by reference to accounts prepared in accordance with accounting standards, and is required to be satisfied when a dividend is declared (or paid). This requires that a company prepare a balance sheet as at that time in order to satisfy the test. However, because of the time required to prepare a balance sheet in accordance with accounting standards, this would never be feasible – there must always be a gap between the balance date and the date when the balance sheet is prepared. In the normal course, a company will decide to pay a final dividend on the basis of its audited accounts, which will usually be finalised several months after the end of the financial year. The test needs to recognise this.[1] One way to do this would be to provide that the company, in applying the balance sheet test at the payment date, is entitled to rely on the most recent audited or reviewed balance sheet (assuming it has been prepared in accordance with the Act as at the most recent statutory balance date), unless a reasonable person would no longer believe that there is a surplus of assets over liabilities at the payment date.

3. Thirdly, the test may not be easy to apply for smaller companies. The question of what is an asset or liability - particularly involving contingencies - is often a difficult accounting question. Small proprietary companies are not actually obliged to prepare accounts in accordance with accounting standards: they are only obliged to keep written financial records that "would enable true and fair financial statements to be prepared and audited" (s286, s292). So a small proprietary company may well not actually know, without more

[1] It is important to note that the preparation of a balance sheet in accordance with accounting standards is a complex and time-consuming exercise. A company may have financial records which allow it to prepare management accounts on a more regular basis but these will not be prepared in accordance with accounting standards. For example, they will typically not include adjustments to fair values that might be required in audited accounts.

expensive accounting analysis than it would otherwise require, whether it has a net asset excess or not. We would recommend that for small proprietary companies that do not prepare statutory accounts, that the balance sheet test be determined by reference to the accounting records that they do have to keep.

4. The new balance sheet test requires that assets exceed liabilities immediately before the dividend is "declared". However, the Act and most company constitutions now provide for the board to "determine" that dividends are payable rather than declare a dividend. Under the Act (section 254V), if the dividend is "declared" it is a debt owing to the shareholders at the time it is declared rather than the payment date. Arguably then, the new provision requires that a dividend cannot be paid unless declared. The obvious way to fix this is to amend the new section 254T so that it does cater for dividends being determined rather than declared.

Impact of the new Personal Property Securities legislation on takeover bids and schemes

A further issue which we would like to raise with you on Monday relates to the impact of the Personal Property Securities Act and Regulations which come into force next year on compulsory acquisition under takeovers (whether by way of takeover bid or scheme of arrangement). The issue here is this:

1. Under the existing law, when a bidder compulsory acquires shares in a target following a takeover bid or under a scheme, the bidder is generally able to acquire those shares free of security interests in favour of third parties. While the bid compulsory acquisition provisions and scheme provisions do not expressly provide for this, under general priority rules the bidder will acquire the target shares free from the prior interests provided that the bidder did not have actual or constructive notice of those interests. Even if the prior security interest is registered (for example, where the target shareholder is a company and has granted a registered charge over all of its assets and undertaking, including its shares in the target), the bidder is not regarded as having constructive notice of that interest unless the bidder would have had actual knowledge of the interest if it had made the inquiries that would ordinarily have been made by an honest and prudent person.

2. It is clearly of critical importance to a bidder compulsorily acquiring shares following a bid or under a scheme to acquire those shares with priority over prior security interests. While the bidder may, at least in a scheme, have the benefit of a warranty from the transferor of the share that the shares are unencumbered, this is of little practical benefit where the transferor is insolvent or otherwise incapable of meeting its obligations on that warranty.

3. Under the Personal Property Securities Act, this issue is dealt with by section 50 which states that

> **50 Taking investment instrument free of security interest**
>
> *Main rule*
>
> (1) A purchaser (see subsection (3)) of an investment instrument, other than a secured party, takes the instrument free of a security interest in the instrument if:
>
> (a) the purchaser gives value for the instrument; and

(b) the purchaser takes possession or control of the instrument.

Exception

(2) Subsection (1) does not apply if the purchaser takes the instrument with actual or constructive knowledge that the taking constitutes a breach of the security agreement that provides for the security interest.

(3) In this section:

purchaser, in relation to an investment instrument, means a person who takes the instrument by sale, lease, discount, assignment, negotiation, mortgage, pledge, lien, issue, reissue or any other consensual transaction that creates an interest in personal property.

Under section 297 of the PPS Act, a person (the ***first person***) has ***constructive knowledge*** of a circumstance if the first person would have had actual knowledge of the circumstance if the first person had:

(a) made the inquiries that would ordinarily have been made by an honest and prudent person in the first person's situation; or

(b) made the inquiries that would be made by an honest and prudent person with the first person's actual knowledge in the first person's situation.

4. The issue here is that purchaser is defined in section 50(3) as a person who takes the shares by sale etc. "*or any other consensual transaction that creates an interest in personal property*". It is arguable that compulsory acquisition following a takeover bid or under a scheme of arrangement is not a "consensual transaction", and that therefore the bidder will not get the benefit of the section 50 extinguishment provision. If this is the case, it would appear that the bidder will also not have the protection which exists under the current law by virtue of the general priority rules, because the intention of the PPS Act appears to be that if an interest is not extinguished under the express extinguishment provisions in the Act, the general priority rules will no longer apply to give priority.

This issues was raised with Attorney-General's Department during the consultation on the PPS Act and Regulations earlier this year, however it would appear that that Department felt that this was an issue beyond the scope of the consultation process. In March this year, the Attorney General's department published various comments and responses on its website (see http://www.ag.gov.au/www/agd/agd.nsf/Page/PersonalPropertySecurityReform_PPSDownloads). On the subject of s 50, those comments state:

Issue: 'Consensual' transactions; impact on efficacy of takeovers.

AGD Comment: The extinguishment of security interests through a compulsory acquisition following a takeover or a scheme of arrangement has policy implications beyond the scope of the review of personal property securities.

We do not understand the Attorney-General's Department's comment that the issue has policy implications beyond the scope of the review of PPS, given that all that is being sought is a continuation of the position that exists under the current law once the PPS commences. The Committee therefore seeks your assistance in bringing this issue to the attention of the Attorney

General's Department, hopefully leading to a clarifying amendment of the legislation before it commences next year.

We look forward to discussing this and the dividend issue with you on Monday.

Kind regards,

Guy Alexander
Chair
Corporations Committee