Update – December 2010

Greg Vale of BinetterVale Lawyers has granted us permission to reproduce his article on the Corporations Amendment (Corporations Reporting Reform) Act 2010 ('CRR Act') which has brought about significant statutory changes to the payment of company dividends among other reforms.

We hope you find this article useful.

Should any of your clients' company constitutions require updating our company constitutions comply with the practical implications of the CRR Act.

Changes to Ability of a Company to Pay Dividends

September 19, 2010

BINETTERVALE
LAWYERS

The ability of a company to pay dividends has changed and is potentially much more difficult from 28 June 2010.

The compliance burden on small companies has also increased in that dividends can now only be paid (amongst other criteria) where company accounts prepared in accordance with accounting standards show that company assets exceed liabilities. This is the case even where the company is not required to prepare accounts in accordance with the accounting standards.

Need to update company constitutions

Previously, a company only required profits before it was able to pay a dividend. The existing constitution of companies will contain a requirement that dividends only be paid from profits (reflecting the old dividend rule). Without an amendment to the company constitution, these companies will have to comply with both the new dividend rules and this profits requirement, before they can pay out a dividend.

Further, the timing of declaration of the dividend is fundamental under the new rules.

A company may wish to alter its company constitution to:

• remove the outdated profit requirement, in which case its ability to pay dividends will be tested solely against the new dividend rules; and

• clarify the timing of declaration of a dividend so as to determine when the obligation to pay a dividend becomes a debt owing to shareholders.

The new test explained

The profits rule has been replaced by a new three pronged test in section 254T(1) of the *Corporations Act 2001* which provides that:

"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 **("balance sheet test");** and

(b) the payment of the dividend is fair and reasonable to the company's shareholders as a whole **("fair and reasonable test");** and

(c) the payment of the dividend does not materially prejudice the company's ability to pay its creditors **("creditor test")."**

Accounting Standards

Assets and liabilities for the purposes of the balance sheet test must be calculated in accordance with accounting standards in force at the relevant time.

The balance sheet test requires that accounting standards be used to determine whether a company has positive net assets. This requirement creates an extra compliance cost for small proprietary companies since such companies are not reporting entities and as such are not legally required to produce audited financial reports which comply with accounting standards. The balance sheet test may force such companies to pay for expert accounting advice to determine whether they can pay a dividend.

The use of accounting standards can occasionally be problematic. The issue of what constitutes an asset or liability for accounting standards can sometimes be difficult to determine, particularly in relation to contingent liabilities. The particular choices that a company makes in applying accounting standards (e.g. fair value or historic cost) may also affect its net asset position. Notably, internally generated intangible assets such as a trademark, brand, masthead or goodwill are not recognised by the accounting standards as an asset. This means that where the bulk of a company's assets comprises internally generated intangibles and its liabilities exceed its other recognised assets, then the company will not be able to pay out a dividend. This is so even if the company has profits.

Fair and reasonable test

Directors of a company which has different share classes with different dividend entitlements will need to consider whether a dividend payment satisfies the fair and reasonable test in the new dividend rules. This is particularly so where a dividend is proposed to be paid to one class of shareholders to the exclusion of other classes of shareholders. Currently it is not clear what the term "fair and reasonable" means in the dividend context.

Where directors are considering paying differential dividends then they should review the dividend rights attached to all classes of shares on issue and consider how they can justify making such differential dividends. Such considerations should be documented and consideration may be had as to whether it is possible to obtain the other shareholders' written consent to such differential dividends. This is to forestall any challenge by a non-recipient shareholder that the fair and reasonable test has not been met.

Declaration of dividend

The fact that the balance sheet test is applied immediately before the dividend is "declared" raises a commercial issue because it requires a company to "declare" a dividend. Many company constitutions do not contain provisions to "declare" a dividend because if a dividend is "declared" it becomes a debt owing to shareholders at the time of the declaration as opposed to the time of payment. Such company constitutions instead contain provisions which allow directors to determine that a dividend is payable.

To deal with the concern about a declaration creating a debt owed by the company and the requirement of the balance sheet test that the dividend be declared, one possible approach would be for directors to determine a dividend payment and then immediately before the scheduled time of payment, declare the dividend. Directors should have their company constitutions reviewed to ensure that they can declare dividends.

Share Capital Reduction Provisions

It is not clear whether a dividend paid under these new dividend rules from share capital (which effectively is a reduction in share capital) must also satisfy the share capital reduction rules in Chapter 2J of the *Corporations Act 2001*. It may be that such a proposed dividend must also meet these other rules. Such a proposed dividend may also raise share capital tainting issues under the tax law which would need to be explored.

By Greg Vale of Binettervale Lawyers

Disclaimer

The information provided in this document is for your general information only. It is not intended that anyone adopt this information to their personal circumstances without first seeking professional advice.