

# Submission to the Commonwealth Treasury

## Proposed Amendments to the Corporations Act

### Discussion Paper

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#### Introduction

This submission addresses the release of the Commonwealth Treasury's discussion paper, *Proposed Amendments to the Corporations Act* (2011). The suggestions focus on the test that should be applied when determining whether or not a company may pay dividend to its members.

If any of the responses require further explanation please contact Dr Marina Nehme at the UWS School of Law at [m.nehme@uws.edu.au](mailto:m.nehme@uws.edu.au).

#### General Observations:

The discussion paper, *Proposed Amendments to the Corporations Act* (2011), considers amending certain provisions in the legislation. It reviews some of the amendments of the *Corporations Act 2001* (Cth) that took place in June 2010.

The following submission mainly focuses on the test that applies to the payment of dividend. The observations in this submission can be summarised as follows:

- Retaining s 254T but making alteration to the section to deal with the concerns raised regarding the application of this provision.
- Removing the word declared from s 254T and bringing the terminology used in this section in line with s 254U.

- Retaining the provisions regarding capital maintenance.

## Test for Payment of Dividend

The payment of dividend characterises the return on investment by shareholders of the company.<sup>1</sup> For a long period of time, the principles governing the payment of dividend were based on the English system which required that dividend should only be paid out of profit. The application of such a test however was problematic. One of the major concerns related to the fact that the word 'profit' was not defined. Further, the guidance from the court decisions regarding the meaning of 'profit' was deemed outdated, complex and not in line with the current accounting standards.<sup>2</sup>

To remedy these concerns, in June 2010, the test for the determination of the payment of dividend was altered. Section 254T(1) now states:

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

Consequently, there was a move away from the profit test. For dividend to be paid, all the requirements in s 254T(1) must have been complied with. However the new test has been subject to criticism. In addition to the disadvantages of this test which were mentioned in the discussion paper on page 6, other concerns have been raised:

- One question that may be raised relates to whether or not the new provision requires the accounting standards to be applied at the time of payment in addition to the time when the financial results are signed off on. If that is the case, what accounts should be relied on at the time of payment of the dividend? Should these accounts be audited?<sup>3</sup>
- The meaning of creditor under s 254T(1)(c) has raised some queries. Is the reference to company's 'creditors' a "reference to the persons who would be entitled to prove in a hypothetical winding up"?<sup>4</sup>

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<sup>1</sup> Kris Arjunan and Chee Keong Low, 'Dividends: A Comparative Analysis of the Provisions in Hong Kong and Australia' (1995) 5 *Australian Journal of Corporate Law* 455, 455.

<sup>2</sup> Wai-Meng Chan, S Susela Devi, Sai-Leong Lee and Kok-Thy Ng, 'Convergence to International Financial Reporting Standards (IFRS): The Need to Tighten the Rule on Divisible Profit' (2010) 4(17) *African Journal of Business and Management* 3588, 3591.

<sup>3</sup> Jason Harris, Anil Hargovan and Michael Adams, *Australian Corporate Law* (Lexis Nexis, 3<sup>rd</sup> ed, 2011), 644.

<sup>4</sup> *In the Matter of Centr Properties Limited and CPT Manager Limited in its Capacity as Responsible Entity of Centro Property Trust* [2011] NSWSC 1171 (5 October 2011), [48].

- When considering s 254T(1)(b), the following question may be raised: what would constitute fairness to the members? For instance, if a company refuses to pay dividend to members as it wishes to preserve cash and raise its capital, would this be deemed as unfair to shareholders?<sup>5</sup> Determining the answer to this question is important as studies have highlighted that retail shareholders may influence which dividend policy the company is going to adopt.<sup>6</sup>

The Treasury has identified four options for dealing with the dividend test. This submission supports option 1 with some reservations.

### **Option 1: retaining section 254T of the Act as currently drafted.**

The submission supports this option with some reservations. Instead of altering the whole test, a proposal is made to keep the test but amend some of the wordings of the section to deal with the concerns raised about the application of this provision.

Some of the proposed amendments are:

- A clause may be added in s 254T regarding companies that do not currently have to comply with some or all of the accounting standards. Such companies should be able to make an assessment regarding whether the company's assets will exceed its liabilities based on the information provided in the financial records of the company.
- The word 'declared' should be altered to fall in line with s 254U.
- Regarding complying with accounting standard, clarification needs to be made on when the accounting standards should be applied? Should they be applied at the time of payment of dividend in addition to the time when financial results are signed off on? Further, an assessment of the cost of compliance with such provision has to be made.
- Clarification of the meaning of creditor for the purpose of s 254T may be required.

### **Option 2: Adopting a solvency test**

While this test has merits, altering s 254T may lead to uncertainty as the test has been altered recently. The current test under s 254T should remain in place with some alteration to deal with the concerns raised by the application of the test. Further, option 2 is not perfect and is also subject to criticisms as noted in the discussion

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<sup>5</sup> Harris, Hargovan and Adams, above n 3, 644.

<sup>6</sup> King Fuei Lee, 'Retain Minority Shareholders and Corporate Reputation as Determinant of Dividend Policy in Australia' (2010) 18(4) *Pacific-Basin Finance Journal* 351.

paper on page 7. One of the main concerns is that the test does not have an express link with the accounting standards.

### **Option 3: Reinstating the profits-based test**

The submission rejects such a proposal as the profits-based test is problematic. That is why it was altered in the first place. Returning to this test will only exacerbate the problems that already existed with the old system.

### **Option 4: Adopting new arrangements under which a company would have two ways of determining whether it could pay dividend**

The submission rejects such a proposal. This option will only lead corporations to choose the option that is more practical to them rather than what may be deemed as a good option. This option basically is the easy option for a legislator to choose if the legislator does not want to make the difficult decision on what test should be applied when determining the dividend payment. Further, option 4 does not necessarily make good law. One test and one test only should be applied to determine when dividend may be paid.

### **Use of 'Declared'**

The submission supports the proposal to alter s 254T as the terminology in s 254T should be in line with the one used in s 254U. This will ensure consistency of the legislation and will lessen the confusion that may arise from the application of these provisions.

### **Inter-relationship between the dividend test and capital maintenance provisions**

The submission does not believe that a legislative amendment is required regarding this matter. The payment of dividend in contravention to s 254T may lead to a reduction of capital. Further, the payment of dividend may fall under the financial assistance prohibition.<sup>7</sup>

### **The application of the test to group companies**

No comment.

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<sup>7</sup> See for example: *Ventura Investment Management Limited, in the matter of Ventura Investment Limited* [2011] FCA 721 (20 June 2011).

## **Conclusion**

The test applied when deciding whether dividend may be paid is a very important test. This test should provide protection to creditors and members of a company. While the current test suffers from deficiencies, it is better than its predecessor as it allows for the application of a more objective test when determining whether dividend may be paid. Consequently, the submission supports the option of retaining the current test. However, a proposal is made to make certain alterations to the test to deal with the concerns raised regarding its application.

Dr Marina Nehme

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