JONES DAY

AUGUST 2010

CHANGES TO AUSTRALIAN LAW ON THE PAYMENT OF DIVIDENDS

OVERVIEW

On 28 June 2010 significant changes to the dividend payment regime under the *Corporations Act* 2001 (Cth) came into effect. The changes apply to dividends declared on or after 28 June 2010. Rather than being able to pay dividends out of profits, a company may now pay a dividend only if it has satisfied three requirements, which focus on a balance-sheet test and the protection of shareholders and creditors.

OLD PROFITS TEST

The Corporations Act previously required that dividends be paid only out of a company's "profits". Whilst the rationale behind this requirement was to protect a company's creditors, there were a number of long-standing concerns about the profits test. These concerns arose out of a number of issues, including the fact that the term "profits" was not defined in the Corporations Act; changes in the nature of the Australian accounting principles used to calculate profits had occurred over time; and the "capital maintenance" doctrine, which had originally underpinned the rationale for the profits test, was increasingly seen as irrelevant to Australian law.

NEW THREE-LIMB TEST

The Corporations Act now provides that a company may pay a dividend only if it meets a three-limb test, namely:

- The company's assets must exceed its liabilities (as calculated in accordance with relevant accounting standards then in force) immediately before the dividend is declared and the excess must be sufficient for the payment of the dividend;

- The payment of the dividend must be fair and reasonable to the company's shareholders as a whole; and

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- The payment of the dividend must not materially prejudice the company's ability to pay its creditors.

The three-limb test is prohibitive in nature. In other words, unless the three limbs are each satisfied, a company cannot pay a dividend. Contravention of the new test is a criminal offence.

ANALYSIS OF THE NEW THREE-LIMB TEST

The first limb of the test requires that net assets be determined in accordance with the accounting standards in force at the relevant time at which the dividend is "declared" (even if the standard does not otherwise apply to the financial year of the company seeking to pay the dividend). There are two concerns that arise out of the first limb. First, the reference to "declaring" a dividend sits uncomfortably with the provisions of many companies' constitutions and market practice, pursuant to which (as permitted under the Corporations Act) directors routinely "determine" rather than "declare" a dividend. It is worth noting that a consequence under the Corporations Act of "declaring" that a dividend is payable is that a debt is then incurred which directors may be liable to pay if the company was insolvent at the time of declaration. Certainly the language in the Corporations Act amendments implies that a dividend cannot be paid until the directors first "declare" the dividend. Second, the first limb of the test pre-supposes that a company has prepared a balance sheet at the time it declares a dividend, notwithstanding that we would have thought that in practice, most companies will be seeking to rely on their most recently audited or reviewed balance sheet to determine whether there are sufficient net assets to pay a dividend. Where there is a gap in time between preparation of the audited accounts and declaration of a dividend, the degree of reliance that directors can place on the audited accounts for satisfying the first limb of the test remains unclear.

The second limb of the new test prohibits payment of a dividend unless it is fair and reasonable to all shareholders. Although this concept is drawn from the existing Corporations Act requirements that must be satisfied in respect of a shareholder-approved capital reduction, the Act does not define what is "fair and reasonable" for these or capital reduction purposes. The interplay between this requirement and the flexibility that proprietary (as opposed to public) companies have under other provisions of the Corporations Act to include in their constitution a provision entitling directors to pay dividends—subject to the terms on which shares are issued—"as they see fit" is also uncertain.

The third limb of the new test, in requiring that payment of a dividend not materially prejudice a company's ability to pay its creditors, also draws upon an existing requirement under the Corporations Act that must be satisfied to implement a shareholder-approved capital reduction. The dividend amendments to the Corporations Act note, for example, that payment of a dividend would materially prejudice creditors if the company were to become insolvent as a result of the dividend payment. However, this is perhaps the most clear-cut of illustrations as to when the third limb of the new test might not be satisfied: for instance, there remains little judicial guidance about what constitutes "material prejudice" in the context of a capital reduction, although recent cases illustrate that the threshold here is reasonably high and must at least involve something beyond theoretical or abstract risk.

While the government has suggested that the new three-limb test offers greater flexibility by replacing the profits-based test for payment of a dividend with the balance-sheet test, the addition of the shareholder and creditor protection mechanisms may actually add complexity to the payment of dividends in some circumstances and increase compliance and governance burdens for boards. Unfortunately, these burdens may ultimately detract from the legislative progress that is otherwise represented by the abolition of the profits linchpin.

IMPACT OF CHANGES

There are four immediate impacts of the change in law around dividend payments that we believe are worth highlighting for directors:

- *Differences arising from the balance-sheet test:* Clearly the balance-sheet test, in certain circumstances, may not allow a company to pay a dividend even if it were able to do so under the old profits test. For instance, a company may still make a profit in its relevant accounting period but have insufficient net assets to be able to pay a dividend under the first limb of the new test. Accordingly, directors should be careful to ensure that their decision-making process in applying the new balance-sheet test is not inadvertently influenced by past practice, which was to pay dividends whenever there were sufficient profits.

- *Timing issues:* The new balance-sheet test requires assessment of sufficient net assets at the date of *declaration* rather than the date of payment of a dividend. Conversely, the shareholder and creditor limbs of the test appear to require those determinations to be made at the date of *payment* of the dividend.

- *Company constitutions:* Older-style company constitutions—particularly those of private companies—may be based on the old Corporations Act test and allow a dividend to be paid only out of profits. Constitutions which contain these types of provisions will need to be amended and updated to reflect the new three-limb test. Payment of a dividend that complies with the new three-limb test pursuant to a company constitution which still imposes the old profits test raises the risk that directors will act without sufficient constitutional power in making the payment and expose themselves to liability in doing so.

- *Additional directors' considerations:* As is the case with shareholder-approved capital reductions, directors will now need to ensure that they carefully work through the second and third limbs of the new test before paying a dividend. From a practical perspective, this means that director deliberations and decision making around dividend policy will need to encompass shareholder and creditor considerations, rather than merely an analysis of relevant accounting principles. We note that while in the context of shareholder-approved capital reductions, directors often obtain comfort on "fairness and reasonableness" from independent experts (due to the need for shareholder approval), dividend payments may not be an area in respect of which directors are accustomed to seek external advice to support their internal decision-making process. Directors may now need to apply a different mindset to this process, particularly in the transitional period following the change in law.

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