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Dear Minister,

### **IMPROVING AUSTRALIA'S CORPORATE REPORTING FRAMEWORK – CHANGES TO DIVIDEND RULES**

I have pleasure in enclosing a further submission by the Corporations Committee of the Business Law Section of the Law Council of Australia ('the Committee') in relation to the proposed amendments to the rules relating to the payment of dividends by Australian companies, which were contained in the Corporations Amendment (Corporate Reporting Reform) Bill 2010 ('the Bill') introduced on 26 May 2010.

Please note that the submission has been endorsed by the Business Law Section. Owing to time constraints, the submission has not been reviewed by the Directors of the Law Council of Australia Limited.

In its submission dated 2 February 2010 on the draft paper released by you on 4 December 2009 (copy **attached**), the Committee indicated that while it supports the adoption of a solvency test to replace the current requirement that dividends be paid only out of profits, what was actually proposed in the draft was the adoption of a balance sheet test (rather than a cash flow test), together with the application of the 'fairness and reasonableness to shareholders' and 'no material prejudice to creditors' tests, used in the context of capital reductions, to all dividends. The Committee also raised a number of practical issues with the proposal.

The Committee notes that the Government has decided to stick with the three tests in the proposed Bill, and does not propose to make any further submissions on those points. There are, however, a number of very practical issues which have arisen with the drafting of the Bill which the Committee believes the Government should address before the Bill becomes law. These are:

1. The new balance sheet test requires that assets exceed liabilities immediately before the dividend is "declared". However, section 254U and most company constitutions now provide for the board to "determine" that dividends are payable rather than declare a dividend. Under 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. Unless the drafting is changed, the new provision may mean that a dividend cannot be paid unless declared.

2. The new provision, in applying the test at the date of declaration rather than the date of payment, also appears to reverse the changes that were made to the Act in 1998 to overcome the effect of the decision of the New South Wales Supreme Court in *Marra Developments Ltd v BW Rofe Pty Ltd* [1977] 2 NSWLR 616. The Committee would therefore recommend that the test be applied at the date for payment of the dividend.
3. Although the explanatory memorandum for the Bill clearly contemplates that the new provision is supposed to operate as an exception to the maintenance of capital rules, it is actually drafted as a prohibition on payment of a dividend unless the three tests are met. The section is unclear as to whether a dividend paid under the new provision is an authorised reduction of capital which does not have to satisfy the requirements of Chapter 2J of the Act. This uncertainty needs to be addressed by explicitly providing that capital can be distributed by way of dividend in accordance with the new provision.
4. The test of whether 'assets exceed liabilities', calculated in accordance with accounting standards, gives rise to several problems:
  - First, as the Committee noted in our earlier submission, it is quite possible that the test will prevent some companies from paying dividends as a result of potentially volatile non-cash adjustments to fair values that are required to be reflected in their balance sheet. This could largely defeat the goal of the proposed reform.
  - Secondly, if the test is required to be satisfied when a dividend is declared (or paid), this would seem to imply that a company must 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.<sup>1</sup> 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.
  - 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:

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<sup>1</sup> 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.

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 expensive accounting analysis than it would otherwise require, whether it has a net asset excess or not. The Committee 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.

5. As stated above, the new provision applies the 'fairness and reasonableness to shareholders' and 'no material prejudice to creditors' tests, which have been borrowed from the reduction of capital provisions (Chapter 2J) to all dividends. While this may be appropriate for dividends that are paid out of capital, for 'ordinary' dividends out of profits (which will be the vast bulk of dividend payments) it is not a reduction in red tape but an increase in compliance requirements. The Committee would strongly recommend that these capital maintenance tests only apply to the extent that a dividend is paid under section 254T other than out of profits.
6. The legislation or the explanatory memorandum should make it clear what is meant in the context of a dividend by the requirement that it be "fair and reasonable to the company's shareholders as a whole". Under the current law, shares of a single class in a public company must all have the same dividend rights unless the constitution provides otherwise (s254W(1)). Dividends on shares in a proprietary company can be paid as directors see fit (s254W(2)). Therefore, for most public companies the new test appears unnecessary. However, for public companies with special dividend rights in their constitutions, and for proprietary companies, the new test appears to impose an additional requirement to those contained in their constitutions. Is this the intention?

If you have any questions please contact either the Committee Chair, Guy Alexander, on [02] 9230 4074 or Michael Hoyle on [03] 9635 9148.

Yours sincerely,



Margery Nicoll  
Deputy Secretary-General

17 June 2010

cc: The Manager  
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The Manager,  
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Dear Sir or Madam,

### Improving Australia's Corporate Reporting Framework

This submission is made by the Business Law Section of the Law Council of Australia ('the Section') in response to the draft reforms to Australia's corporate reporting framework released by the Minister for Financial Services, Superannuation and Corporate Law on 4 December 2009. Please note that owing to time constraints, the submission has not been reviewed by the Directors of the Law Council of Australia.

The Section's submission is concerned with only one of the proposed reforms, namely the proposal to repeal the "profits test" for the payment of dividends currently contained in section 254T and to replace it with a more flexible solvency test.

As you are no doubt aware, the Section has long supported the adoption of a solvency test for the payment of dividends along the lines now proposed by the Government. By way of background, I have attached a copy of the Section's September 2004 submission to Treasury supporting the recommendations in the Position Paper: *Payment of Dividends under the Corporations Act 2001* issued by the Legislation Review Board of the Australian Accounting Review Board (**AARF Position Paper**) and noting the increased importance of those recommendations in light of the then proposed adoption of International Accounting Standards in Australia. For the reasons set out in this submission, the Section continues to believe that this reform is highly desirable and commends the Government for finally taking action to implement it.

While the Section strongly supports the proposal, there are a number of specific issues that it wishes to address. These relate to the following matters:

- o The proposed balance sheet solvency test in section 254T(a).
- o The proposed material prejudice test in section 254T(c).

- o The proposed “fair and reasonable” test in section 254T(b).
- o The absence of any presumptions comparable with section 1324(1B) in relation to the enforcement of the proposed new rules.
- o The need for some consequential amendments to chapter 2J.

This submission is confined to these matters. However, if you would like the Section to elaborate further on its reasons for supporting the proposal as a whole, it would be happy to do so.

***The proposed “balance sheet” solvency test.***

For the reasons outlined below, the Section submits that the balance sheet test should be omitted from the proposed new section 254T. This would be consistent with the recommendations in the AARF Position Paper, which stated: “The balance sheet test, given its use of historical cost values rather than current values for some assets, is not a useful measure and should not be adopted by Australia”.<sup>1</sup> It would also be consistent with the approach adopted in relation to reductions of capital and share buy-backs.

If, contrary to this submission, the Government decides to retain a balance sheet test of solvency in addition to the solvency test under sections 588G and 95A, the Section submits that a number of amendments are required to clarify the operation of the test.

While a number of other jurisdictions have adopted a “balance sheet” solvency test for the payment of dividends, the Section understands that these tests have rarely (if ever) been framed as a simple requirement that a dividend-paying company’s assets (as disclosed in its financial statements) exceed its liabilities (as so disclosed). Rather, directors have been expressly authorised to rely on any valuations of assets, and any estimates of liabilities, they consider reasonable in the circumstances even if these differ from those adopted in financial statements.<sup>2</sup> However, as currently drafted, the proposed new section 254T omits any such authorisation.

As the Explanatory Material (EM) for the Corporations Amendment (Corporate Reporting Reform) Bill 2010 (Bill) points out, one of the principal concerns with the current profits test is the increased volatility of profits that often results from fair value adjustments (realised or unrealised) under International Financial Reporting Standards (IFRS) – see paragraph 3.2 of the EM. However, if any solvency test for the payment of dividends were to be based on a balance sheet prepared in accordance with IFRS, it is quite possible that some companies will still be prevented from paying dividends by potentially volatile non-cash adjustments to fair values that are required to be reflected in such a balance sheet. This would largely defeat the goal of the proposed reform. Accordingly, the Section submits that it is vital the proposed new rules address this issue.

While this could be achieved by careful drafting of the proposed “balance sheet” test, the Section notes that the relevance of a mandatory balance sheet test in this context has been heavily criticised by a number of important commentators in recent times – most

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<sup>1</sup> See section 7.3.

<sup>2</sup> See for example section 4 of the New Zealand Companies Act 1993 and section 42 of the Canada Business Corporations Act. Delaware law also allows assets and liabilities to be revalued to their fair market value in determining the amount of dividends permitted under section 170 of the Delaware General Corporation Law. See also section 6.40(d) of the US Revised Model Business Corporation Act.

notably by Professor Jonathan Rickford.<sup>3</sup> According to Professor Rickford, the heart of the problem is that statutory accounts "have never been, and are becoming increasingly less, designed to determine the amount appropriate for dividends".<sup>4</sup> In his view, a balance sheet surplus is neither necessary nor sufficient to justify the distribution of dividends. He also points out that prudential regulators have explicitly recognised that IAS accounts do not provide a sound basis for prudential decisions of this sort.<sup>5</sup> Notably, a balance sheet:

- o Does not recognise all assets that have economic value.
- o Recognises some assets at historical values.
- o Recognises some assets at "fair values" that are different from market values.

The Section acknowledges that the Rickford proposals have been regarded as controversial in some quarters. Most notably, they were considered in the European Union's "Feasibility study on an alternative to the capital maintenance regime established by the Second Company Law Directive 77/91/EEC of 13 December 1976 and an examination of the impact on profit distribution of the new EU accounting regime" in January 2008<sup>6</sup> and in the subsequent position paper adopted by the DG of Internal Markets and Services.<sup>7</sup> Nevertheless, despite the reservations expressed in these reports, the Section believes the Rickford proposals have much to commend them and should be given serious consideration. As noted above, they are consistent with the recommendation in the AARF Position Paper that a balance sheet solvency test should not be adopted in this context and with the fact that no balance sheet test applies in respect of reductions of capital under section 256B or share buy-backs under section 257A (which raise very similar solvency considerations).

If, after due consideration, the Government decides to retain some form of balance sheet solvency test, the Section strongly recommends that:

- o The test follow international precedents and make it clear that Directors may rely on valuations of assets and estimates of liabilities that are reasonable in the circumstances.<sup>8</sup>
- o Consideration be given to an explicit direction that (absent an express authorisation in the company's constitution) a company's liabilities for the purpose of the test should include any amount that would be needed, if the company were to be dissolved at the time of the distribution, to satisfy the preferential rights upon dissolution of shareholders whose preferential rights are superior to those receiving the distribution.

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<sup>3</sup> See J. Rickford *et al.*, "Reforming Capital: Report of the Interdisciplinary Group on Capital Maintenance", *European Business Law Review*, Vol. 15, 2004 (Rickford Report) and J. Rickford, "Legal Approaches to Restricting Distributions to Shareholders: Balance Sheet Tests and Solvency Tests", *European Business Law Review*, Vol. 7, 2004: 135-179 (Rickford Article).

<sup>4</sup> Rickford Article, p.166.

<sup>5</sup> Rickford Article, p.169.

<sup>6</sup> See [http://ec.europa.eu/internal\\_market/company/docs/capital/feasibility/study-annex1.pdf](http://ec.europa.eu/internal_market/company/docs/capital/feasibility/study-annex1.pdf)

<sup>7</sup> [http://ec.europa.eu/internal\\_market/company/docs/capital/feasibility/study-annex1.pdf](http://ec.europa.eu/internal_market/company/docs/capital/feasibility/study-annex1.pdf)

<sup>8</sup> In this regard, the Section notes that under the proposed reforms the parent entity of a consolidated group (which will cover many significant dividend-payers) will no longer be required to prepare parent entity accounts – see Items 17 and 31 of Schedule 1 to the Bill - although certain disclosures about parent entity assets and liabilities will be required under proposed regulation 2M.3.01. It is therefore unclear from the current draft whether directors are required to have regard to any financial statements under section 254T (a). This uncertainty requires clarification.

### ***The material prejudice test.***

The Section notes that reductions of capital and share buy-backs are required to satisfy a "material prejudice" under sections 256B and 257A and accepts that this test is appropriate where a company is, in effect, reducing its share capital. However, the Section is concerned that this test may impose a significant and unnecessary regulatory burden for routine dividend payments that do not involve a reduction of capital. In order to address this, the Section submits there should be a two-pronged test for the payment of dividends:

- o A dividend that does not involve a reduction of a company's share capital should be required to satisfy a solvency test, but should not be required to satisfy the material prejudice test.
- o A dividend that does involve a reduction of a company's share capital should be required to satisfy both tests.

At first blush, the "material prejudice" test may seem relatively uncontroversial. However, the Section is aware it has given rise to considerable difficulty in other contexts.<sup>9</sup> The meaning of the test is unclear and companies are often required to undertake considerable work when they need to form a view the test will not be breached. This regulatory burden may be appropriate when a company is undertaking an unusual and significant transaction – such as a reduction of capital or a share buy-back. However, in the Section's view, it is not justified where a company is simply proposing to pay a routine interim or final dividend that does not reduce its share capital.

The Section also notes that section 588G already addresses the only example of something that might materially prejudice a company's ability to pay its creditors given in Note 1 to section 254T, namely a dividend that would cause the company to become insolvent. In the Section's view, the solvency test in section 588G is and will remain adequate to deal with solvency issues for routine dividends that do not involve a reduction of capital. Accordingly, the Section submits the proposed new "material prejudice" test should only be required for dividends not permitted under current rules, namely dividends that have the effect of reducing a company's share capital.

### ***The fair and reasonable test.***

The Section also submits the proposed "fair and reasonable" test is unnecessary in light of the requirements that already apply to all dividends under section 254W.

Like the "material prejudice" test, this test again appears to have been "borrowed" from Chapter 2J. However, the Explanatory Memorandum for the Company Law Review Bill 1997 (which introduced Chapter 2J) only identified four factors that might be relevant in determining whether a capital reduction is fair and reasonable to shareholders as a whole, namely:

- (a) the adequacy of any consideration paid to shareholders;

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<sup>9</sup> See Cho, Y-Y and Kishore, V, "The 'material prejudice' test and the financial assistance", (2004) 78 ALJ 194 and Cornwell, P. "Material Prejudice and financial assistance: the financier's viewpoint", (2004) 78 ALJ 746

(b) whether the reduction would have the practical effect of depriving some shareholders of their rights (for example, by stripping the company of funds that would otherwise be available for distribution to preference shareholders);

(c) whether the reduction is being used to effect a takeover and avoid the takeover provisions; and

(d) whether the reduction involves an arrangement that should more properly proceed as a scheme of arrangement.

In the Section's view, three of these (factors (a), (c) and (d)) have no relevance to dividends. Only one - factor (b) - is potentially relevant, but it concerns a matter that is clearly covered by section 254W. Accordingly, in the Section's view, the proposed test will not add anything meaningful to section 254W. However, there is a risk it may cause confusion if people seek to give it some independent operation. In these circumstances, the Section submits it should not be adopted.

#### ***Presumptions and enforcement.***

The Section believes that the proposed reform will considerably reduce the distinction between a dividend and a reduction of capital. In particular, it will be possible for a company to pay a dividend under the proposed new rules that will have the effect of reducing a company's share capital.

In these circumstances, the Section submits that section 1324(1B) should be amended so that similar presumptions should apply in respect of any application for an injunction in respect of an alleged contravention of section 254T.

#### ***Consequential amendments.***

For essentially the same reason, the Section also submits that Chapter 2J should explicitly recognise that a company's share capital may be reduced by way of a dividend in accordance with section 254T.

#### ***Transitional adjustments.***

The Section notes that many companies will have constitutions and/or shares issued on terms that provide dividends may only be paid out of "profits" available for distribution by way of dividend. This may mean that these companies will not be able to take advantage of the proposed new dividend rules until they amend the relevant documents. In light of this, the Section has considered whether it might be appropriate for the Bill to over-rule provisions of this sort. However, on balance, the Section does not consider this to be appropriate. In most instances, it should be fairly straightforward for companies to obtain the approvals required to amend their constitution and/or the terms of issue of their shares. And, in the instances where shareholders may not wish to approve the necessary changes, their decision should not be pre-empted by legislation.

#### ***Conclusion.***

The Section strongly supports the adoption of a solvency test for the payment of dividends to replace the current profits test. However, for the reasons outlined above, the Section believes the proposal outlined in the EM and the Bill should be amended to ensure the new regime can operate smoothly without unintended consequences.

If you would like to discuss any of the points made in this submission, please contact either the Chair of the Section's specialist Corporations Committee, Guy Alexander, on [02] 9230 4874 or Michael Hoyle on [03] 9635 9148.

Yours sincerely,

*Margery Nicoll.*

Margery Nicoll

**Acting Secretary General**

2 February 2010