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Legal Alert

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Declaring Dividends – Moving Away from the "Profits Test"

Key Summary

Directors often use the end of a financial year as a time to reflect on a company's financial performance and, if the company is doing well, to give consideration to whether a dividend should be issued to shareholders.

A recent amendment to the Corporations Act 2001 (Cth) (**Corporations Act**) changes the requirements to be met by a company before it issues a dividend. These changes have taken effect from 28 June 2010, and should be understood by directors before issuing a dividend.

Recent Amendment

Sections 254T – 254V of the Corporations Act deal with matters associated with the issue of dividends by companies.

Until recently, s254T of the Corporations Act (**s254T**) required that dividends be paid out of the profits of a company. Such profits needed to exist at the time of declaration of the dividends, which requirement was made relevant where a dividend was declared at one point in time, but was not payable until a later time.

However, a recent amendment to the Corporations Act included a repeal of s254T and its replacement with a new s254T. The new s254T sets out a "solvency test" that takes effect in respect of all dividends declared after 28 June 2010.

As a consequence of that amendment, a company cannot now pay a dividend unless:

- immediately before the declaration of a dividend, the assets of the company exceed its liabilities and that excess of assets is sufficient to meet the payment of any dividend declared; and
- payment of the dividend is fair and reasonable to the shareholders of the company as a whole; and
- payment of the dividend does not materially prejudice the company's ability to pay its creditors, e.g. if the company were to become insolvent as a result of the payment of the dividend.

Therefore, rather than requiring company directors to adhere to a determination of "profits", a determination which may be difficult to accurately identify in the context of a company's financial circumstances at a given moment, the amended s254T enables directors to make a decision based upon a calculation of the company's assets and liabilities using the accounting standards in force at the time a dividend is declared. The principal benefit of this approach is that compliance will often be more easily obtained.

It remains the case that directors should be careful when they are causing a company to issue a dividend that the tests set out in s254T are met both at the time the decision to declare the dividend is taken, as well as at the time that the dividend is paid.

Amendment of Corporate Constitution Required?

It is very common for the constitution of a company to include a clause that limits the payment of a dividend to the available profits of that company.

If this is the case, then until such time as the company's constitution is amended to take into account the new requirements of s254T, directors should take care before issuing a dividend to ensure that the proposed dividend both:

- meets the tests set out in s254T; and
- is paid only out of profits of the company.

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“Profits”

If a company’s Constitution still includes a limitation that dividends are to be paid only from profits, the question of whether such profits actually exist can only be determined in the circumstances of each particular case and will be dealt with on an accounting basis.

In such circumstances, we note the following matters which directors are well-advised to consider in the context of declaring dividends:

dividends must not be paid if as a result the company is unable to pay its debts – the new terms of s254T clearly capture this issue;

the payment of a dividend may be an act of insolvent trading for the purposes s588G of the Corporations Act in circumstances where s588G(1A) confirms that paying a dividend is an action by which a company incurs a debt;

no dividend should be paid, whether out of capital or profits, if the company is in a state of doubtful trading or solvency unless the directors believe in good faith and on reasonable grounds that the payment of the dividend would not jeopardise the company’s ability to promptly satisfy its creditors, whether secured or unsecured, both presently and in the future.

Consequences of a Breach

A breach of s254T may also give rise to a breach of a director’s duties owed to the company. The introduction of the “solvency test” in the new form of s254T causes the director’s general duty to not to allow a company to trade whilst insolvent to come into sharper focus in respect to issuig dividends.

It may also be the case that a claim may be available against shareholders who receive a wrongly paid dividend, although whether such a cause of action may be sustained will depend upon the state of mind of the recipient shareholder at the time of receiving the dividend payment. While in respect of innocent recipients the position has not been fully clarified, in the case of more informed or involved recipients a substantial risk may arise when, at the time of receiving payment, the recipient has knowledge of the circumstances that give rise to an allegation of wrongful payment.

This article was prepared by Colin Brown, a partner in our insolvency and reconstruction team. We invite you to contact Colin or Michael O’Neill, should you have any questions or require any further information about the matters discussed in this article.

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