

ABILITY TO PAY DIVIDENDS OUT OF CAPITAL: AN END TO THE UNCERTAINTY?

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Legal Briefings - By **George Durbridge**

We are now discovering the true effect of a 2010 amendment of s254T of the Corporations Act 2001 (Cth), which limits a company's power to pay a dividend. Until 2010, the section provided simply that a company might only pay a dividend out of its profits (the 'profits test'). This provision gave statutory force to a principle worked out by the courts, to the effect that dividends could not be paid out of subscribed capital.

In Brief

- There has been enduring uncertainty whether amendments to s254T of the Corporations Act 2001 permits dividends to be paid out of both profits and capital.
- Recent decisions of the Federal Court strongly suggest that under s254T dividends can be paid out of both profits and capital.
- Whether this brings an end to this debate remains to be seen.

Summary

We are now discovering the true effect of a 2010 amendment of s254T of the Corporations Act 2001 (Cth), which limits a company's power to pay a dividend. Until 2010, the section provided simply that a company might only pay a dividend out of its profits (the 'profits test'). This provision gave statutory force to a principle worked out by the courts, to the effect that dividends could not be paid out of subscribed capital.

The common law profits test was part of a scheme of rules designed to prevent avoidance of the provisions of the Companies Acts which set out the only procedure by which a company could return capital to its members. This maintenance of capital principle did not work well in protecting creditors, and it was largely abandoned by amendments made to the then Corporations Law by the Company Law Review Act 1998 and replaced with provisions which require directors to have regard to the company's solvency and the interests of creditors.

The 1998 amendments did not affect s254T, but in 2010 the section was rewritten to require that a company not pay a dividend unless to do so would leave the company an excess of assets over liabilities, would not materially prejudice the company's ability to pay its creditors and would be fair and reasonable to the company's shareholders as a whole. The relevant explanatory memorandum said plainly that the amendment was designed to repeal and replace the profits test. While the new s254T does not mention profits at all, it seems clear that it does not require dividends to be paid out of profits. In particular, in 2011, the New South Wales Supreme Court held that Centro Properties, having satisfied itself that it met the express requirements of new s254T, could pay a dividend out of capital in the course of a scheme of arrangement: *Re Centro Properties Ltd* [2011] NSWSC 1171 at [40]-[44].

Because the new s254T does not refer to profits, however, it has left some scope for doubt whether some form of the profits test still applies, either because the common law profits test continues in force after the old s254T was replaced, or because 'dividend' means a share of profits. Both versions of this view are implausible.

The common law rule was auxiliary to the provisions of the Act restricting return of capital, and no longer had a separate existence after it was overtaken by statutory provisions, most recently the former s254T. That provision had now been repealed, the maintenance of capital principle itself has been abolished and the new requirements of s254T concerning shareholders and creditors are based on the new provisions which govern return of capital, in place of the former maintenance of capital regime.

As recently as 2014, the New South Wales Court of Appeal expressly left open the question whether a 'dividend' must only be paid out of profits. The Court accepted that s254T 'does not maintain the statutory rule that dividends must not be paid except out of profits.' However, it left open the possibility 'that there remains a general law principle that dividends may only be paid out of profits': *Wambo Coal Pty Ltd v Sumiseki Materials Co Ltd* [2014] NSWCA 326 at [57]. This reservation was based on words used in a decision of 1857. That case does not support the Court's reservation: it concerned articles of a company which expressly provided for dividends to be paid only out of profits, words which the judges expressly confined to that context, so provide no assistance in deciding whether a much later provision has dropped that limitation: *Henry v Great Northern Railway Company* (1857) 1 DeG&J 606. Although there have been repeated calls for the position to be clarified, s254T has, unfortunately, not been amended since 2010. The Government has twice proposed amendments, once to reinstate the profits test (in 2012), another time to abolish it (in 2014). Neither amendment has proceeded.

Recent court decisions clarifying the position

Against the above background, in *Grant-Taylor v Babcock & Brown Ltd (In Liquidation)* [2015] FCA 149, the Federal Court found that Babcock & Brown had contravened s254T as it then stood by paying dividends out of capital in 2005, 2006 and 2007. The Court went on to say at [46]: "Since the events of this case occurred there has been a substantial alteration in the law concerning the payment of dividends. As a result of those changes (which were made in 2010) it is now lawful to pay dividends out of capital so long as the payment does not affect the solvency of the company paying the dividend." Curiously, this was not necessary to the decision in the case, except perhaps as an extenuating circumstance.

On appeal, in *Grant-Taylor v Babcock & Brown Ltd (In Liquidation)* [2016] FCAFC 60 at [37]-[39], the Full Court of the Federal Court went a little further. Having agreed with the Federal Court that Babcock & Brown had contravened the old s254T by paying dividends out of capital before 2010, the Full Court said: "The Act was changed in 2010 and the legal requirement to pay a dividend out of profits was removed and replaced with [the requirements set out above] ... It is not in dispute that under the current law the declaration and payment of the relevant dividends ... would have been lawful." Again, this remark was not strictly necessary to the Court's decision.

Conclusion

It is to be hoped that these statements in the Grant-Taylor decisions, while not strictly authoritative, will dispel the doubt that has hung around new s254T, whether it means any more than it says, that if a company deals with the three requirements set out in that section, it can pay a dividend, whether out of profits or capital. Whether this is now the end of the debate remains to be seen.

More information

For information regarding possible implications for your business, contact [George Durbridge](#).

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