The company dividend restriction: Does it promote good corporate governance?

James Routledge

Peter Slade

INTRODUCTION

In the normal course of events in the life of a company, profits are declared and dividends can be paid out of profits. In a perfectly competitive capital market, where there is perfect information, the market value of a company’s shares is the present value of the expected net cash flows to be received from the share, discounted at a required rate of return which reflects the opportunity costs of these net cash flows (dividends). Under these circumstances, the notion of expectations influencing the price of shares is invalid since all agents would have all the information about the market and future share prices. In less than perfectly competitive capital markets, which is the norm, it is not possible to know with certainty what a company’s future dividend flow might be, so rules of thumb are often used as approximations. An example of this is the price to earnings ratio wherein the share price would rise if there were to be a perceived increase in the returns to the share.

Under these circumstances there might exist an incentive for a company’s management to declare greater profits on a period’s business trading than is actually the case. If such high profits could be maintained for some length of time then, all things being equal, the share price would rise. This incentive to inflate profits would be enhanced if the senior management of the company were partly remunerated by being granted some of the company’s shares or options on the shares. Clearly, an increasing share price means that management’s remuneration would rise.

Sources of funds for the exaggerated profits declarations and higher dividends have to be considered by the management. One such source could conceivably be the company’s working capital. It is possible to use funds generated by reducing the working capital through using efficiency enhancing devices such as just-in-time management (which is the judicious reduction of holdings of raw materials and sub-assemblies and other inputs into production processes), sound inventory management, overhead reduction, and so on. Such developments are all to the good; increased efficiency leads to improved profits, higher dividends and rising share prices. This is the stuff of proper business operation. On the other hand, there may be a temptation to simply plunder a company’s working or circulating capital.
Use of working capital to finance increased profit declarations without a corresponding increase in efficiency obviously jeopardises the longevity of the company, which is clearly not in the owners’ or shareholders’ interests. Thus there exists a conflict between senior management and owners. Further, there would be a conflict of interest between senior management and the rest of the company’s employees, who stand to lose their jobs and accrued entitlements in the event of insolvency or takeover by another company. Moreover, there is a conflict of interest between the company and debt holders. This arises in several ways. First, paying out working capital to equity holders increases the company’s debt to equity ratio, which simultaneously increases the riskiness of the company’s future capacity to finance debt. Second, the draw down of working capital might be financed through increasing debt. The debt to equity ratio thus increases even more, and this represents a shifting of funds from debt holders to equity holders.

Generally there are proscriptions upon the inappropriate use of working capital described above. One of these proscriptions is the restriction on the payment of company dividends in s 254T of the Corporations Act 2001 (Cth). Section 254T states that a dividend may only be paid out of the profits of a company. The purpose of the prohibition is not explicitly stated in the legislation.1 Mason CJ discussed the restriction in Industrial Equity Ltd v Blackburn (1977) 137 CLR 567 at 576, and noted that it had a long history in the English courts prior to its inclusion in Australian company law. His discussion showed that the restriction stems from the capital maintenance rule in Trevor v Whitworth (1887) 12 App Cas 409, which provides that the creditors of a company “are entitled to assume that no part of the capital which has been paid into the coffers of the company has been subsequently paid out, except in the legitimate course of its business”.2

The focus of the operation of s 254T is on the term “profit”: what a company might distribute as a dividend is governed by the determination of the company’s profit in a given period. As company profits are assumed to lead to an accretion of capital, the restriction that distribution of dividends is only to be from profits should maintain the company’s capital.

A recent position paper by the Legislation Review Board of the Australian Accounting Research Foundation called for a review of the current dividend payment regime.3 The position paper suggested that the existing dividend provision with its focus on capital maintenance is outdated, and recommended consideration of alternative proposals. Similar views regarding the shortcomings of the existing law and the need for reform have been canvassed for some time. For example, Fletcher and Mason considered the dividend restriction at the time of the implementation of the Companies Act 1981, and concluded that due to the uncertainty and complexity of the law as it had developed to that point there was a “need of fundamental reform”.3 In addition, Factor, when commenting on the lack of reform at the time of the introduction of the First Corporate Law Simplification Act 1995 (Cth), stated that it was “quite incongruous that, for Australia, the existing rules over dividends are proposed to remain”.6 Similarly, Arjunan and Low suggested that it was a gross anomaly for Australia not to have undertaken reform of dividend law considering its advanced corporate regulatory regime. In light of the renewed focus on the operation of the current dividend payment restriction, and in consideration of current concern with the general standard of corporate governance in Australia, it is timely to consider the effectiveness of the current dividend law and whether it might be improved.

---

1 The absence of an explicitly stated purpose distinguishes s 254T from other capital maintenance provisions in the Corporations Act 2001 (Cth). For example, the share capital transaction provisions that restrict share capital reductions and share buy-backs are explicitly stated as intending to protect the interests of shareholders and creditors by minimising the risk of transactions that might threaten a company’s solvency. Despite the absence of a stated objective in the legislation, the capital maintenance provisions have a basis in the common law principle set out in Trevor v Whitworth (1887) 12 App Cas 409.

2 Trevor v Whitworth (1887) 12 App Cas 409 at 423-424, per Lord Watson.


This article considers aspects of the development of the law associated with the dividend payment restriction. We assess whether the existing substantive law is effective in promoting sound decision-making by corporate officers who are required to determine the timing and quantum of dividend payments. Our analysis indicates that the existing provision in s 254T is unlikely to have a significant positive effect on dividend decision-making, and suggests that reform of the existing provision is appropriate. The article concludes by briefly reviewing some of the proposals for reform.

THE LEGAL VIEW OF PROFITS

The term “profit”, which is central to the operation of s 254T in the Corporations Act 2001, is not defined in the legislation, nor is an appropriate method for its calculation provided. The focus on profit in the dividend restriction is problematic, as calculation of profits can be undertaken by various means, each providing a different amount that might be distributed as a dividend.

The starting point for many cases that have required a consideration of the definition of profits is reference to the judgment in Re Spanish Prospecting Co Ltd [1911] 1 Ch 92. In defining the term “profits” Fletcher Moulton LJ stated: 8

Profits implies a comparison between the state of a business at two specific dates usually separated by an interval of a year. The fundamental meaning is the amount of gain made by the business during the year. This can only be ascertained by a comparison of the assets of the business at the two dates.

Fletcher Moulton LJ’s definition is based on a “stock of capital” approach to determining profits. Under this approach, profit is determined by measuring net assets (capital) at two points in time. Profit is derived if there is an accretion of net assets over time, that is, only after capital has been maintained. The “stock of capital” approach is sufficiently comprehensive to allow profit calculation to include trading gains (revenue less expenses which result in an overall accretion of capital), and gains or losses not directly connected with the routine conduct of the business. These gains or losses would include, for example, adjustments for such items as the diminished service potential of wearing assets and increases in value of fixed assets.

The comparison of net assets approach to the determination of profit was readily applied in the circumstances of Re Spanish Prospecting, as there had been a liquidation of the company’s assets and there was no question as to the size of the fund available for payment of dividends. In his judgment, Fletcher Moulton LJ recognised there would be some difficulty in applying his definition of profit in other circumstances. He noted that strict application of the definition in making out accounts “would often be difficult in practice” 9 and went on to state the general principle that profits must be calculated as “closely as possible in accordance with the fundamental conception or definition” he had outlined. 10 Fletcher Moulton LJ acknowledged the difficulty that would be encountered in making a periodic assessment of profits in a business, and accepted that the strict meaning of profits is not usually observed in drawing up company accounts.

Australian courts have accepted to varying degrees this definition of profits. A cautious acceptance was evident in FCT v Slater Holdings Ltd (1984) 156 CLR 447 at 460 where Gibbs CJ referred to the “comparison of assets” approach to determining profit as a “guide” that was not of universal application. A less cautious acceptance and application of the definition is found in QBE Insurance Group Ltd v ASC (1992) 38 FCR 270 where Lockhart J adopted the definition of profits set out in Re Spanish Prospecting. In discussing the appropriateness of the definition, Lockhart J commented that: 11

The statement of principle that profit should be calculated by reference to changes in the value of assets of a business during the relevant financial period in Re Spanish Prospecting is as valid today as it was in 1911 when expounded.

8 Re Spanish Prospecting Co Ltd [1911] 1 Ch 92 at 98.
9 Re Spanish Prospecting Co Ltd [1911] 1 Ch 92 at 99.
10 Re Spanish Prospecting Co Ltd [1911] 1 Ch 92 at 101.
The early definition of profit outlined in *Re Spanish Prospecting* is consistent with general concepts of income and profit accepted and promoted by the accounting profession. The definition is consistent with the notion of comprehensive income offered by the United States’ Financial Accounting Standards, which states:12

Comprehensive income is the change in equity (net assets) of an entity during a period from transactions and other events and circumstances from nonowner sources.

There is some correspondence between the legal definition and accounting concept of profit in Australia at the conceptual level. The term “profit” is not specifically defined in the Australian statements of accounting concepts. Net profit (or loss) is recognised as being the difference between revenues and expenses, which are defined in terms of changes in a company’s claim to future economic benefits that affect equity in a given period.13 However, reporting under Australian accounting standards has recently moved toward the comprehensive view of profit. This is the result of the requirement that additional information be presented in the statement of financial performance regarding changes in a company’s capital that are not the direct result of recognition of revenues and expenses.14

The obvious difficulty with the legal definition is that it is little more than a conceptual statement. For this reason it is unlikely to be informative to company officers required to make decisions about the pool of profits available for payment of dividends. A further problem with the definition is that it does not refer to an underlying capital maintenance principle. Henderson and Peirson noted that the comprehensive income approach “does not specify the characteristics of profit. It simply indicates how profit should be measured.”15 For example, when comparing the value of net assets to determine profit and ultimately dividends, it is not clear if corporate officers should merely refer to the monetary value of assets or if they should give consideration to maintaining productive capacity or general price level changes. The definition provides no guidance on questions such as this, which can be critical in terms of protecting the interests of company creditors and shareholders.

Considering the broad conceptual nature of the legal definition of profits, the comment of Gibbs CJ in *FCT v Slater Holdings Ltd* (1984) 156 CLR 447 at 460 that the definition outlined in *Re Spanish Prospecting* should be viewed only as a useful guide seems entirely appropriate. The legal definition is rudimentary in light of the complex transactions that might be the subject of its consideration. To be effective in promoting corporate governance, a dividend restriction provision based on the calculation of profit would seem to require a more explicit definition of profit.

**FIXED AND CIRCULATING CAPITAL**

Another development associated with the legal definition of profits is the notion of the categorisation of capital as either “fixed” or “circulating”. The first substantial reference to this dichotomy of capital was set out in *Verner v General and Commercial Investment Trust* [1894] 2 Ch 239. In *Verner’s case*, the company held various security instruments. The market value of the securities had fallen which resulted in an overall diminution of the company’s assets. The question before the court was whether the losses associated with the decreased value of the securities had to be made up before dividends could be paid from current period investment gains (described as an excess of income over expenses). The securities were deemed by the court to be representative of fixed rather than circulating capital, therefore, the losses associated with their decrease in value were not required to be made up before dividends could be paid from current period gains. Lindley LJ set out the principle that:16

---


13 Australian Accounting Standards Board (AASB), Statement of Accounting Concepts 4, “Definition and Recognition of Elements of Financial Statements”.

14 Accounting Standard AASB 1018 “Statement of Financial Performance” at [4.3] states that “this Standard requires disclosure in a separate component of the statement of financial performance of non-owner changes in equity not recognised in net profit or loss”.


16 *Verner v General and Commercial Investment Trust* [1894] 2 Ch 239 at 266.
fixed capital may be sunk and lost, and yet the excess of current receipts over current payments may be
divided, but that floating or circulating capital must be kept up, as otherwise it will enter into and form
part of such excess, in which case to divide such excess without deducting the capital that forms part of
it will be contrary to law.

The legal distinction between fixed and circulating capital enabled the courts to apply the
principle that past losses did not have to be made good before dividends could be distributed from
current period profits. The diminution of fixed capital was not required to be considered in the
determination of the pool of dividend funds. However, circulating capital was to be maintained,
thereby preventing the diminution of capital that had been subject to transactions related to the current
commercial activity of the company.

The expression “fixed and circulating capital” was introduced in an argument presented to the
courts that made reference to early writers on political economy. It is, therefore, informative to briefly
review the concept of capital and its division into fixed and circulating capital from an economic
standpoint from which the legal definition originated.

The early writers on political economy conceptualised capital as the stock of goods used in
production, and which itself has been produced. In conventional economic use, it is generally taken to
mean real capital, that is, physical goods. In everyday commercial use the meaning is expanded to
include the total resources of an organisation or person used in business operations. Thus, in the wider
sense capital may be used to mean money capital, which is a stock of money resulting from past
saving. From this a distinction is made between fixed capital, which consists of durable goods such as
buildings, plant and equipment and so forth, and circulating capital, which consists of stocks of raw
materials, semi-finished goods, components and the like. Circulating capital also includes the funds
embodied in stocks and work in progress or other current as opposed to fixed assets. Accordingly, it
may be seen as working capital, being that part of current assets financed from long-term funds.

Subsequent legal application of the notion of a distinction between fixed and circulating capital is
generally consistent with the economic definition described above. Circulating capital was associated
with outlay or consumption that results in income in a particular period. The concept resembles the
accounting practice of matching current period revenues and expenses: capital which is circulated
forms part of the expenses to be deducted from revenues in determining profit. This seems clear from
the comment by Lindley J in Re National Bank of Wales [1899] 2 Ch 629 at 671, where he stated that:

circulating capital, or any other money employed in earning returns, must be deducted from them in
order to ascertain how much of them can be regarded as profit If the returns do not exceed the money
spent in procuring them … there can be no profits.

This was the view taken by Warrington LJ in Ammonia Soda Company Ltd v Chamberlain [1918] 1 Ch 266 in his comment on circulating capital outlined in Verner’s case. He noted that “such
proper deductions must be made is, I believe, all that Lindley LJ meant in the passages relating to
circulating capital”.

Scrutton LJ expressed a similar view of circulating capital:

When you take receipts in an ordinary period, and to earn those receipts you have parted absolutely
with some of your capital, as when you have sold goods for a price, you must not treat the price as net
profits without deducting the value of the goods which you have parted with in order to obtain the
price; in other words, you cannot treat as net profits what are actually gross profits.

Similarly, the definition of circulating capital provided by Swinfen Eady LJ in Ammonia Soda
Company Ltd v Chamberlain stated:

17 See comments in argument in Lee v Neuchatel Asphalte Company (1889) LR 41 Ch D 1 at 13, which were commented on by
Swinfen LJ in Ammonia Soda Company Ltd v Chamberlain [1918] 1 Ch 266 at 286. See also the references made in the
judgment of Scrutton LJ in Ammonia Soda Company Ltd v Chamberlain [1918] 1 Ch 266 at 297-298. Farwell J in Bond v
Barrow Haematite Steel Company [1902] 1 Ch 353 at 365 referred to the comments of the economist Alfred Marshall on the
distinction between fixed and circulating capital.


19 Ammonia Soda Company Ltd v Chamberlain [1918] 1 Ch 266 at 291.

20 Ammonia Soda Company Ltd v Chamberlain [1918] 1 Ch 266 at 297.
It is a portion of the subscribed capital of the company intended to be used by being temporarily parted with and circulated in business, in the form of money, goods or other assets, and which, or the proceeds of which, are intended to return to the company with an increment, and are intended to be used again and again, and to always return with some accretion.

Swinfen Eady LJ went on to give two illustrative examples of circulating capital. First, he referred to the use of capital by a trader in purchasing goods for resale who intends to receive the capital “back again with profit arising from the resale of goods”. Second, he mentioned a banker lending (or circulating) money who hopes to receive the capital “back with interest”. He noted that the amount of circulating capital expended must be “charged against, or deducted from, receipts before the amount of profits can be arrived at”.21

This early judicial discussion of the circulating capital corresponds closely with the normal accounting method of calculating current period profit by deducting current period expenses from revenues. The nub of the definition in terms of capital maintenance is that overall capital may be reduced if the portion of it that has been appropriated for circulation does not return with some surplus value.

While the notion of maintenance of circulating capital appears straightforward, its application has led to some confusion. For example, in Bond v Barrow Haematite Steel Company [1902] 1 Ch 353 the court viewed assets such as leases and property, plant and equipment as circulating capital. The court took this view based on the underlying use of the assets. The company concerned was involved in large scale smelting works and had acquired mine leases and associated infrastructure to supply themselves with ore as an alternative to purchasing it as required. The ore extracted from these mines was used exclusively for the purposes of the company’s works. Evidence indicated that it was common practice to regard money invested in such items as circulating capital. This meant that the investment in these assets needed to be deducted from income derived from the use of the asset in determining profit available for distribution.

Scrutton LJ criticised the judgment in Bond for “extending Lindley LJ’s proposition to wear and tear of fixed capital, which is not parted with at all, and has treated the wear and tear of buildings as circulating capital which must be made good”. He referred to the political economy definition of circulating capital as “capital which fulfils the whole of its office in the production in which it is engaged by a single use”.22

Considering the above, it is not surprising that Mason J in Industrial Equity Ltd v Blackburn (1977) 137 CLR 567 at 577 referred to the notion of the difference between fixed and circulating capital as an “obscure distinction”.

Modern accounting practice does not rely on the notion of fixed and circulating capital. It is not a concept that relates to generally accepted accounting practice applied in the determination of corporate profits; however, the concept retains currency in Australian law. Arguably, the continued development of law based on concepts that are obscure and divergent from current commercial and accounting practice contribute little to maintaining or improving corporate governance. The following discussion of the judgment in QBE Insurance Group Ltd v ASC (1992) 38 FCR 270 further highlights this problem with the current approach.

THE QBE INSURANCE DECISION
The decision in QBE Insurance Group Ltd v ASC (1992) 38 FCR 270 related to the implementation of Accounting Standard AASB 1023, which applied to companies carrying on general insurance business. One of the requirements of the standard was that insurance companies must include unrealised movements in the market values of investment assets23 in their revenue accounts.24 The company argued that bringing to revenue unrealised changes in the value on investments as required

21 Ammonia Soda Company Ltd v Chamberlain [1918] 1 Ch 266 at 287.
22 Ammonia Soda Company Ltd v Chamberlain [1918] 1 Ch 266 at 297-298.
23 The QBE insurance group, as part of their business operation, invested insurance premiums in “investment assets” such as government securities, shares, debentures, bonds and notes, mortgages, loans, deposits and properties.
under the standard would distort reported profits and prevent the company from presenting a true and fair view in accounting reports. One of the questions addressed by the court was whether it was appropriate to recognise unrealised gains as profit, which could then be distributed as dividends.

The criteria that had been previously established to determine whether an unrealised gain could be distributed as a dividend were (1) that there had to be an overall accretion in capital, and (2) that the accretion was of a permanent character. The requirement that the accretion was to be of a permanent nature limited the possibility that notional profits might be distributed in circumstances where the realised increases in asset values from which they were derived might be reversed in the short term. In the *QBE Insurance case* the second test may not have been met, as the market values of the investments concerned were demonstrably volatile. Therefore, the court was faced with the problem that the Accounting Standard required recognition of the unrealised gains as profit, while the common law view was that such gains did not fall within the definition of profit due to a lack of “permanence”.

The solution to this difficulty presented by Lockhart J added further complexity to the definition of profits. He proposed that if the unrealised gains were derived from investment of circulating capital, they could appropriately be distributed as dividends:

> The investment assets of the applicants with which this case is concerned in my view constitute their circulating capital. This case is therefore distinguishable from cases which apply the principle that unrealised accretions to the value of a company’s capital may be available for dividend only when it is clear that the accretion in value is of a permanent character.

There are a several problems with this approach. Perhaps the foremost problem is that the decision placed further emphasis on the obscure distinction between fixed and circulating capital in determining profits. Furthermore, the decision eroded the capital maintenance principle that unrealised gains should only be distributed when they are considered to be of a permanent nature.

It is also arguable that the decision applied the concept of circulating capital in a manner that was quite different to previous judicial discussion of the concept. In the *QBE Insurance case* the gains being considered were unrealised, yet previous judicial discussion of the circulating capital concept suggested it related to current period profit ascertained by deducting realised current period expenses from revenues. Application of the notion of circulating capital to unrealised gains was, therefore, too inconsistent with its use in earlier decisions. Lockhart J cited *London Australia Investment Co Ltd v FCT* (1977) 138 CLR 106 as authority for the proposition that the nature of banking and insurance business was such that unrealised gains in its investments should be recognised as profit. The paragraph of the judgment in *London Australia Investment* referred to stated that:

> All profits arising from that activity are profits of the business of banking or insurance. At any time and from time to time the property acquired may need to be sold, in whole or in part, to meet the requirements of the banking or insurance business and the hope and expectation is that in the meantime not only will the property have earned income but that it will have risen in value. The scale of activity coupled with the source of the funds leads to the inference that a purpose or intention of the acquisition is resale at a profit.

It is difficult to see that this passage supports the contention that where there has been an unrealised gain on investment of so called “circulating capital”, a profit should be recognised. The passage states that profit may arise from “earned” or realised income related to the use of an asset, or, alternatively, profit may be derived on sale (realisation) if there has been an accretion in the asset’s value. The following passage from *Colonial Mutual Life Assurance Society Ltd v FCT* (1946) 73 CLR 604 at 618 was also cited by Lockhart J in support of the view that unrealised gains should be included as profit:

---

the sounder view is that profits and losses on the realisation of investments of the funds of an insurance company should usually be taken into account in the determination of the profits and gains of the business.

Again, reference is to “profits and losses on realisation” which does not support the contention that unrealised gains should be recognised provided the underlying transaction involves the use of the elusive “circulating” capital.

Unrealised accretion in the value of assets held for investment does not involve a consumption of assets that can be deducted from returns to calculate actual profit. Therefore, to apply the notion of circulating capital to unrealised gains is not consistent with the application of the concept in earlier decisions.

The decision in QBE Insurance has, arguably, added to the complexity of the task of determining profits available for distribution as dividends, and provides further evidence of the inadequacy of the operation of the current dividend restriction provision.

PROPOSALS FOR CHANGE

The above discussion of the current state of the dividend restriction highlights that the existing dividend law is complex, uncertain and possibly no longer relevant to the current commercial context in which it applies.

Should the legislature continue with an approach to dividend restriction that requires a determination of corporate profits, improvement would be achieved by including a definition of profit in the legislation. An earlier proposal for reform along these lines was made by Fletcher and Mason who suggested that consideration be given to reshaping the law in accord with the provisions of the Companies Act 1980 (UK),

That Act was (and remains) similar to the Australian law in that it focuses on capital maintenance by prohibiting payment of dividends other than from profits. However, the legislation provides a definition of profits and guidance as to when those profits are available for distribution. Section 263(1) of the Companies Act 1980 (UK) states the general rule that a company shall not make a distribution except out of profits. Company profits available for distribution are defined in s 263(3) as “accumulated, realised profits, so far as not previously utilised by distribution or capitalisation, less its accumulated realised losses, so far as not previously written off in a reduction or reorganisation of capital duly made”. The broad definition of distribution in s 263(2) includes every distribution of a company’s assets to its members whether in cash or otherwise. Section 264(1) prescribes that a public company may only make distributions if, at the time, the amount of its net assets is not less than called up share capital and undistributable reserves.

The United Kingdom legislature recently issued a White Paper on company law reform in response to a report by The Company Law Review Steering Group. The Government White Paper indicated support for implementation of the Steering Group’s proposals. The Steering Group strongly recommended retention of the existing capital maintenance based dividend restriction. The Steering Group’s reasons for recommending that the existing rules be retained were that:

1. They were necessary to achieve prudence in the disposal of company assets to members.
2. They were necessary for the maintenance of capital.
3. Any shift from a capital maintenance focus would be a major departure from the established European approach.

28 Mason and Fletcher, n 4.
29 The rules are now in the Companies Act 1985 (UK) and are substantially similar to those contained in the earlier legislation.
30 See the Companies Act 1985 (UK) ss 263-264.
31 United Kingdom Secretary of State for Trade and Industry, Modernising Company Law, issued July 2002.
A further recommendation of the Steering Group was that, where appropriate, greater emphasis should be given to the accounting standards in determining profits.\textsuperscript{34} If the definition of “profit” remains central to the dividend rule in Australia it may also be appropriate to give similar emphasis to the role of current accounting standards. Greater emphasis on application of contemporary accounting practice would provide substantially more guidance to decision-makers and an approach that is transparent and more widely understood than the existing complex common law rules. Furthermore, as many of the accounting standards provide for what are considered to be reliable measurement procedures, defining profit on the basis of current accounting standards may enhance the capital maintenance objective.\textsuperscript{35} Reliance on reported profits would be consistent with the observation by Lockhart J in \textit{QBE Insurance} that close regard be given to the views of the accountancy profession in measuring profits.\textsuperscript{36}

An alternative proposal for reform to the dividend restriction is to change the focus of the dividend restriction from capital maintenance to a solvency test. This is the approach suggested by the Australian Accounting Research Foundation through its Legislation Review Board. Their position paper pointed to the lack of a definition of profit as a significant shortcoming of the existing law. Furthermore, it was suggested that replacing the existing approach with a solvency test would:

- bring the dividend payment provision into line with the provisions for share buy-backs, capital reductions and the removal of par value of shares;
- bring the Australian law into line with trends in overseas jurisdictions; and,
- reinforce directors’ responsibilities in terms of a company’s solvency.

The Board commented that increased focus on solvency would reinforce directors’ responsibility in respect of maintaining solvency.\textsuperscript{37}

A solvency test is required for dividend distributions under the \textit{New Zealand Companies Act 1993}.\textsuperscript{38} Factor compared the existing Australian dividend restriction with the solvency test approach under the New Zealand Act and concluded that “Australian company creditors may be afforded less protection than their New Zealand counterparts due to the complexity and uncertainty of the Australian law”.\textsuperscript{39} However, adoption of a solvency test seems to set a lower threshold for the availability of assets for distribution to shareholders. This raises a question as to whether there is any additional protection afforded to creditors and shareholders in requiring that dividends be paid only when there has been some accretion in capital as a result of profitable business operations. As the United Kingdom Steering Group suggested, the retention of a capital maintenance approach may be necessary to achieve prudence in the disposal of company assets to members.\textsuperscript{40} If the limit of dividend distributions is determined on the basis of whether the payment will cause or lead to insolvency, there may be a temptation for decision-makers to plunder the company’s capital. This may, in turn, have a negative effect on the longevity of the company.

CONCLUSION

This article has considered whether the current restriction on payment of dividends embodied in s 254T of the \textit{Corporations Act 2001} is effective in promoting sound corporate governance. Our

\textsuperscript{34} The Company Law Review Steering Group, n 32, p 219.
\textsuperscript{35} An example of this is the operation of AASB 1037, “Self-Generating and Regenerating Assets”. Prior to the implementation of the standard in 1998 such assets were generally recorded at historical cost. The standard requires reporting of net market values rather than historical cost. The Standard notes (at p 48) that “using net market value enables the profit and loss statement to reflect a more relevant measure of the periodic performance of an entity that controls SGARAs than is the case using historical costs”.
\textsuperscript{36} \textit{QBE Insurance Group Ltd v ASC} (1992) 8 ACSR 631 at 649.
\textsuperscript{37} Legislation Review Board of the Australian Accounting Research Foundation, n 3, p 3. The \textit{Corporations Act 2001} (Cth) already requires that solvency be considered in relation to the payment of dividends by operation of the insolvent trading provisions. Under s 588G(1A), payment or declaration of a dividend is an action that can invoke liability for insolvent trading.
\textsuperscript{38} See \textit{New Zealand Companies Act 1993} s 4.
\textsuperscript{39} Factor, n 6 at 259.
\textsuperscript{40} The Company Law Review Steering Group, n 33.
analysis suggests that reform of the existing dividend payment restriction is long overdue. With increased focus on issues associated with the adequacy of corporate governance it is necessary that any dividend payment restriction provide clear guidance for decision-makers. We suggest that the existing provision is unlikely to have a significant positive effect on this aspect of corporate decision-making. The definition of “profits” on which the s 254T provision is based is poorly developed, and provides little or no guidance to corporate officers making decisions about the suitability of distributing company assets as dividends.

If the current capital maintenance approach to the dividend payment restriction is to continue, then greater clarity as to the definition of profits is needed to facilitate efficient operation of the law. Succinct criteria governing dividend payments will also provide information that will allow creditors and shareholders to adequately assess dividend decisions. This might be accomplished by a defining “profit” in the legislation, which is the approach taken in other jurisdictions such as the United Kingdom. An alternative view is that the capital maintenance approach should be removed and replaced with a solvency test. This approach would strip away the unnecessary complexities associated with the current provision. However, a question arises as to whether removal of the capital maintenance approach to the dividend restriction might lead to detrimental erosion of working capital.