



# CORPORATE LAW: MLL221



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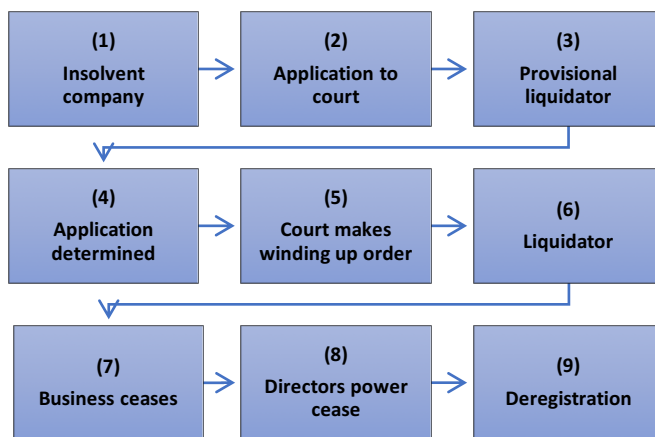
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# CHAPTER 10 – DIVIDENDS

## Key Points:

- The rules governing the procedure for payment of dividends are contained in either the replaceable rules or in a company's constitution (if any).
- Under the replicable rules, directors have the power to pay dividends. If a company's constitution provides for declaration of dividends, the directors usually have the power to recommend that a dividend to be paid and the shareholders can only declare a dividend up to the recommended amount. Shareholders cannot override the powers of the directors not to pay a dividend even where the company's assets sufficiently exceed its liabilities.
- Dividends may be paid if the company's assets exceed its liabilities and the excess is sufficient for the payment of the dividend.
- Payment of a dividend must be fair and reasonable to shareholders as a whole and must not materially prejudice the company's ability to pay its creditors.
- A payment of dividends if assets do not exceed liabilities may result in civil penalty orders against the directors because of a breach of the reduction of capital or insolvent trading provisions. Directors may also breach their fiduciary duties, especially where creditors are adversely affected.

## Creditors:

A person or company to whom money is owing

## Injunction:

A judicial order restraining a person from beginning or continuing an action threatening or invading the legal right of another, or compelling a person to carry out a certain act, e.g. to make restitution to an injured party.

## Imputation Credits:

Franking Credits also known as Imputation Credits are a type of tax credit that allows Australian Companies to pass on tax paid at the company level to shareholders. The benefits are these franking credits can be used to reduce income tax paid on dividends or potentially be received as a tax refund.

## Procedure for payment of dividends

Dividends are payments to shareholders and represent a return on the shareholder's investment in the company.

The procedure for payment of dividends is set out in the replaceable rules or constitution. The rules governing the procedure for payment are contained in either the **replaceable rules in section 254U and 254W(2)** or the dividend provisions in the company's constitution if that is applicable.

While a cash payment is the most common form of dividend, a company may also pay dividends by an issue of shares. Such dividends are referred to as "bonus shares".

| Corporations Act 2001 – Section 254U<br>Other provisions about paying dividends  |
|--|
| (1) The <a href="#">directors</a> may determine that a dividend is payable and fix: <ul style="list-style-type: none"><li>(a) the amount; and</li><li>(b) the time for payment; and</li><li>(c) the method of payment.</li></ul> The methods of payment may include the payment of cash, the issue of shares, the grant of options and the transfer of assets. |
| (2) Interest is not payable on a dividend.   |

## Who decides whether to pay dividends?

The replicable rule in **section 254U(1)** gives directors the power to pay a dividend without the needs for a prior dividend declaration by shareholders. This rule enables directors to determine that a dividend is payable, fix the amount, determine the time for payment and the payment rule.

Because **section 254U** is a replaceable rule, it can be displaced or modified by a provision in a company's constitution.

### Example:

A clause in a company's constitution that a dividend may only be paid if it is declared by shareholders at a general meeting on the recommendation of the directors.

A company does not incur a debt to shareholders merely by fixing the amount or time for payment as a dividend.

| <b>Corporations Act 2001 – Section 254V</b><br><b>When does the company incur a debt?</b>  |
|--|
| (1) A company does not incur a debt merely by fixing the amount or time for payment of a dividend. The debt arises only when the time fixed for payment arrives and the decision to pay the dividend may be revoked at any time before then. |
| (2) However, if the company has a constitution and it provides for the declaration of dividends, the company incurs a debt when the dividend is declared.  |

### *Deputy Commissioner of Taxation v Blue bottle UK Ltd [2006]:*

A company's constitution may provide for the declaration of a dividend within the meeting of section 254V(2) even though it describes the power of the directors as being to "determine" rather than to "declare" a dividend as these words have the same meaning in this context.

As a general rule, shareholders cannot force a company to pay dividends even if it has sufficient surplus assets to do so: *Burland v Rarle [1902]*. However, in exceptional circumstances a refusal by a profitable company to pay dividends may be part of a broader pattern of behaviour that amounts to oppressive or unfair conduct for purposes of remedy under **section 232**: *Sanford v Sanford Courier Service Pty Ltd (1986)*.

### *Wambo Coal Pty Ltd v Sumiseki Materials Co Ltd [2014]:*

Shareholders may be able to force the company to declare a dividend in circumstances where the company is lawfully able to do so and the terms of a company's constitution indicate that it was the intention of the parties that a shareholder would be entitled to a fixed, mandatory dividend with no requirement for a separate decision by the directors to declare or pay the dividend and no right of the company to withhold payment.

## Interim Dividends

It is quite common for a company's constitution to draw a distinction between the payment of interim and final dividends. This allows dividend payment to be staggered through the course of the year. A decision to pay an interim dividend requires the directors to make a judgement as to the company's financial position and its eventual profit.

A decision to pay interim dividends can be revoked or amended before the dividend is paid: *Brookton Co-operative Soc Ltd v FCT (1981)*.

## Dividend Rights

| Corporations Act 2001 – Section 254W<br>Dividend Rights  |
|--|
| Shares in public companies<br>(1) Each share in a class of shares in a public company has the same dividend rights unless:<br>(a) the company has a constitution and it provides for the shares to have different dividend rights; or<br>(b) different dividend rights are provided for by special resolution of the company.  |
| Shares in proprietary companies (replaceable rule--see <a href="#">section 135</a> )<br>(2) Subject to the terms on which shares in a proprietary company are on issue, the <a href="#">directors</a> may pay dividends as they see fit.   |
| No liability companies<br>(3) A person is not entitled to a dividend on a share in a no liability company if a call:<br>(a) has been made on the share; and<br>(b) is due and unpaid.<br>(4) Dividends are payable to the shareholders in a no liability company in proportion to the number of shares held by them, irrespective of the amount paid up, or credited as paid up, on the shares.<br>This <a href="#">subsection</a> has effect subject to any provisions in the company's constitution relating to shares that are not ordinary shares. |

Dividends are payable to those entered on the company's share register as members at the time the dividend is payable or is declared.

In the case of public companies, [section 254W\(1\)](#) specifies that each share has the same dividend rights unless the company has a constitution that provides for the shares to have different dividend rights or different dividend rights are provided for by a special resolution of the company. In the case of proprietary companies, [section 254W\(2\)](#) contains a replaceable rule that allows directors to pay dividends as they see fit.

[Section 254W\(3\) and \(4\)](#) sets out special rules for no liability companies. A shareholder of a no liability company is not entitled to a dividend if a call has been made on the share that is due and unpaid. Further, subject to provisions to the contrary in a no liability company's constitution, dividends are payable in proportion to the number of shares held, irrespective of the amount paid up on them

## Net Assets Solvency Test

A company must not pay a dividend unless three requirements are met under [section 254T](#).

| Corporations Act 2001 – Section 254T<br>Circumstances in which a dividend may be paid  |
|--|
| (1) A company must not pay a dividend unless:<br>(a) the company's assets exceed its liabilities immediately before the dividend is declared and the excess is sufficient for the payment of the dividend; and<br>(b) the payment of the dividend is fair and reasonable to the company's shareholders as a whole; and<br>(c) the payment of the dividend does not materially prejudice the company's ability to pay its creditors.<br>Note 1: As an example, the payment of a dividend would materially prejudice the company's ability to pay its creditors if the company would become insolvent as a result of the payment.<br>Note 2: For a <a href="#">director's</a> duty to prevent insolvent trading on payment of dividends, see <a href="#">section 588G</a> .<br>(2) Assets and liabilities are to be calculated for the purposes of this section in accordance with accounting standards in force at the relevant time (even if the standard does not otherwise apply to the financial year of some or all of the companies concerned). |

According to the note to [section 254T](#), the payment of a dividend would materially prejudice the company's ability to pay its creditors if the company would become insolvent as a result of the payment.

Assets and liabilities for the purposes of the **section 254T(1)(a)** net assets test are calculated in accordance with accounting standards in force at the relevant time (even if the standard does not otherwise apply to the financial year of the company concerned): **Section 254T(2)**.

## Remedies for Improper Dividend Payments

### Unauthorised Reduction of Capital

Where dividends are paid when there is not a sufficient excess of assets over liabilities, this may amount to a reduction of capital.

According to section **256B(1)** a company may reduce its capital if the reduction:

- Is fair and reasonable to shareholders as a whole; and
- Does not materially prejudice the company's ability to pay its creditors; and
- Is approved by shareholders under section 256C

If the reduction does not satisfy the **section 256B(1)** requirements, the company contravenes section 256D. While the contravention does not invalidate the dividend payment, any director involved may be liable for a civil penalty order under **section 256D(2) and (3)**.

| <b>Corporations Act 2001 – Section 256D</b><br>Consequences of failing to comply with section 256B  |
|---|
| (1) The company must not make the reduction unless it complies with <a href="#">subsection 256B(1)</a> .<br>(2) If the company contravenes <a href="#">subsection (1)</a> :<br>(a) the contravention does not affect the validity of the reduction or of any contract or transaction connected with it; and<br>(b) the company is not guilty of an offence.<br>(3) Any person who is involved in a company's contravention of <a href="#">subsection (1)</a> contravenes this <a href="#">subsection</a> .<br>(4) A person commits an offence if they are involved in a company's contravention of <a href="#">subsection (1)</a> and the involvement is dishonest. |

### Insolvent Trading

| <b>Corporations Act 2001 – Section 588G</b><br>Director's duty to prevent insolvent trading by company   |
|--|
| (1) This section applies if:<br>(a) a person is a <a href="#">director</a> of a company at the time when the company incurs a debt; and<br>(b) the company is insolvent at that time, or becomes insolvent by incurring that debt, or by incurring at that time debts including that debt; and<br>(c) at that time, there are reasonable grounds for suspecting that the company is insolvent, or would so become insolvent, as the case may be; and<br>(d) that time is at or after the commencement of this Act. |

Payment of a dividend by an insolvent company may be considered "insolvent trading."

Under **section 588G(1A)**, a company is regarded as having incurred a debt when a dividend is paid or, if the company has a constitution that provides for the declaration of dividends, when the dividend is declared.

When a company is wound up, directors who contravened **section 588G** may be personally liable to either the company's liquidator or particular unsecured creditors for any loss or damage suffered because of the company's insolvency: **section 588M**.

## Breach of Directors' Duties

| Corporations Act 2001 – Section 254T<br>Circumstances in which a dividend may be paid  |
|--|
| (1) A company must not pay a dividend unless:<br>(a) the company's assets exceed its liabilities immediately before the dividend is declared and the excess is sufficient for the payment of the dividend; and<br>(b) the payment of the dividend is fair and reasonable to the company's shareholders as a whole; and<br>(c) the payment of the dividend does not materially prejudice the company's ability to pay its creditors.<br>(2) Assets and liabilities are to be calculated for the purposes of this section in accordance with accounting standards in force at the relevant time (even if the standard does not otherwise apply to the financial year of some or all of the companies concerned). |

Under [section 254T\(1\)\(c\)](#) a dividend payment must not be materially prejudice the company's ability to pay the creditors. Payment of a dividend by an insolvent company may constitute a breach of duty by the directors.

Directors who authorise a dividend payment in circumstances breach their fiduciary duties and may be held personally liable to repay the amount to the dividend to the company: *Hilton International Ltd v Hilton (1988)*.

Directors may also breach their duty of care if they arrange for their company to pay a dividend if they do not make appropriate inquiries as to whether the company has assets that sufficiently exceed liabilities immediately before the dividend is declared: *ASIC v Loiterton [2004]*.

### Injunction to Restrain Dividend Payment

Contravention to [section 254T](#) may trigger an application for a [section 1324](#) injunction to restrain the company from paying the dividend.

Shareholders' interest would be affected if a dividend was not fair and reasonable to them and therefore they would have standing to apply for an injunction. Creditors would also have standing to apply for a [section 1324](#) injunction where a dividend payment materially prejudices' the company's ability to pay them.

### Taxation of Dividends

Under the imputation system, the tax paid by a company is imputed to shareholders by means of imputation credits attached to the dividends they receive called "franked dividends." The current company tax rate is 30%.

Franked dividends plus an amount equal to the imputation credits attaching to them are included in a shareholder's assessable income. Australian resident shareholders, however, are entitled to a tax offset in the form of a rebate of the imputation credit applicable to those dividends. The imputation credit is 30/70ths of a dividend.

As a general rule a company must frank a dividend to the extent of the credit or surplus balance in its franking account at the time the dividends paid. Credits to a franking account arise when a company pays a tax instalment. They also arise when a company receives a franked dividend from another company. Franked dividends paid by a company to its shareholders are debited from its franking account.

A company must provide a dividend statement in an approved form when it pays dividends to its shareholders. This tells shareholders the extent to which their dividends are franked and the amount of the imputation credit attaching to them.

To the extent that a dividend is unfranked there are no imputation credits attached. Such dividends are included in the assessable income of shareholders and are taxed in their marginal rates.