Piper Alderman

Dividends – beware the new changes

The Australian Government's recent changes to the law concerning a company's ability to pay dividends potentially may undermine sound corporate structures involving Australian companies. Corporate Partner, Craig Yeung and Associate, Kylie Barrie explore some of these issues.

There has been surprisingly little discussion surrounding one of the most fundamental changes to the *Corporations Act* in recent times. Under recent changes, dividends can be paid regardless of whether the company has profits.

Dividends now may be paid, irrespective of whether the company has current year or retained profits, if the company satisfies a three stage test.

Under the new three stage test, section 254T of the Act allows a company to pay a dividend if:

- the company's assets exceed its liabilities immediately before the dividend is declared and the excess is sufficient for the payment of the dividend;
- the payment of the dividend is fair and reasonable to the company's shareholders as a whole; and
- the payment of the dividend does not materially prejudice the company's ability to pay its creditors.

One of the reasons the Government gave for amending the *Corporations Act* was that the definition of "profits" was not widely agreed upon and as such caused difficulties for companies when determining whether it could pay dividends out of profits. The question was often whether to use the legal precedent of the meaning of profit, or the accounting standard. The Government has maintained that the abolition of the profit test eliminates this issue for companies.

While at first glance section 254T appears to allow more flexibility for companies to pay dividends, it has a number of consequences that companies should be aware of.

Corporate groups are often structured so that a holding company holds shares in numerous operating subsidiaries, each of which runs a part of the group's business. These subsidiaries are often debt financed by holding company loans and may, for asset protection reasons, have a deficiency of assets against liabilities whilst being solvent because of support from the holding company. Notwithstanding this deficiency, the subsidiary may be profitable and its cash flows may be needed by the holding company.

Under the old law, the holding company would have been able to draw on the profits from the subsidiary by way of dividends. Under the new law, however, the subsidiary would not be able to pay dividends to the holding company because the subsidiary's liabilities exceed its assets.

Therefore, company groups should consider whether or not the new law will impact on how the group is able to extract profits of subsidiaries to the holding company. Furthermore, the new dividend payment rules may impact on how future corporate groups are structured (for example whether and to what extent it should be debt funded by the holding company) so that dividends are able to be paid to the holding company if necessary. Finally, company groups should consider other corporate structuring or asset protection strategies that would offer similar protections under the new law.

Other potential considerations include a review of the company's constitution to see whether the provisions on dividends require dividends to be paid out of profits. If so, they should amend their constitution to avoid having to satisfy the profits test in addition to the new law. Similarly, when incorporating a new company consideration should be given to the dividend provisions when drafting the constitution.

The new law, specifically the test of whether "assets exceed liabilities", may not always be easy for smaller companies to apply. Determining what is an asset or liability can sometimes be a difficult accounting question and given that small proprietary companies may not prepare accounts in accordance with accounting standards, it may impose an unnecessary, expensive burden on the company.

Failing to understand or appreciate how the new dividend rules impact on a company or corporate group may result in a payment of a dividend being an illegal return of capital, resulting in potential liability for company directors.

Australia seeks to promote itself as a player in arbitration

Australia wants to increase its role as a regional, and beyond, centre for international arbitration. Dispute Resolution Partner, Andrew Robertson, reports.

Globalisation has a range of impacts. One seen in the law is that increasingly parties are engaging in cross-border transactions and arrangements. Sometimes those transactions or arrangements don't proceed as everyone involved would wish and disagreements arise. Identifying which system should be used to resolve the dispute can be a difficult question with parties in different countries and subject to different legal systems.

This is not a recent realisation. Over 50 years ago it was recognised that efficient arbitration can provide a means of resolving disputes, potentially in a system rooted in neither of the disputants' home jurisdictions. For that to work there needed to be international rules for the recognition of arbitration agreements and the enforcement of arbitral awards. The United Nations took up the issue. The result was the New York Convention (the Convention on the Recognition and Enforcement of Foreign Arbitral Awards).

There are now 142 countries, plus the Holy See and the Cook Islands, that have adopted the New York Convention. This means that it is now easier, and often therefore preferable, to enforce a foreign arbitral award rather than a foreign Court's judgment.

Over the last 50 years a specific body of jurisprudence has developed in relation to international arbitration. It mixes elements of civil law and common law creating a system that is both familiar and distinct for legal professionals from differing backgrounds.

Australia believes it has not been doing enough to get its share of international arbitration and that it could do more to attract international arbitration. It has a lot of natural advantages:

- a first world economy with an open and efficient legal system
- a pool of talented and skilled legal practitioners
- a multicultural society which is familiar with and welcoming to a range of differing cultural backgrounds.

> *"Identifying which system should be used to resolve [a] dispute can be a difficult question with parties in different countries and subject to different legal systems."*

In order to promote Australia, a series of tangible steps have been taken: the international arbitration law has been modernised, the domestic arbitration law has been harmonised with the international arbitration law, there has been investment by Government and private players in constructing specialised arbitration centres and Australia's Courts have appointed specialist arbitration Justices.

Modernisation of Australia's international arbitration legislation

The United Nations Commission on International Trade Law (UNCITRAL) developed a Model Law that member States may utilise to assist in the harmonisation of arbitral laws. Australia adopted the Model Law in 1989 but since then the UNCITRAL Model Law has been amended.

Except for one area, *ex parte* preliminary orders, Australia has now adopted the current UNCITRAL Model Law. Further, Parliament took the opportunity to make a series of changes to its International Arbitration Act to bring it into line with international best practice. For example, Australia's position on the confidentiality or the absence of an implied confidentiality) in arbitral proceedings was out of step with many other arbitral centres. The International Arbitration Act now creates implied rights of confidentiality for arbitrations in Australia. Other judicial decisions of the past that are seen as out of step with modern arbitral practice will now be subject to legislative amendments to create a modern arbitral environment.

Parties considering Australia as the seat or place for arbitration can be confident that the procedural law applicable to the arbitration will be modern and consistent with international jurisprudence.

Harmonisation of domestic arbitration legislation with its international counterpart

Australia's domestic arbitration law, while harmonised between the Australian States and Territories, was quite distinct from the international arbitration law. The States and Territories have now agreed to harmonise their domestic arbitration laws with the international arbitration legislation. There will be some differences reflecting the particular requirements for domestic arbitration but the majority of the law will be the same or very similar for domestic and international arbitration.

While this simplifies Australia's arbitral framework it also has the added advantage that Australian legal practitioners and Courts will now develop greater exposure to the legislation as provisions are consistent thus further broadening Australia's arbitral expertise. It will also mean that domestic arbitrators will not need to re-familiarise themselves with a significantly different system providing a greater choice in potential arbitrators for parties to select from.

Specialist arbitration lists in State and Federal Courts

A number of the Courts in Australia have also generated specialist arbitration lists with nominated Judicial officers to ensure that parties have their matters heard before Justices experienced in arbitration.

The Australian Federal Court has issued a Practice Note for Proceedings under the International Arbitration Act and also appointed a Judicial Officer in each registry as an Arbitration Coordinating Judge.

The Victorian Supreme Court similarly has created the Arbitration List (List G) of the Commercial Court and has appointed a well known former arbitrator as its Judge in charge of the list. Likewise the New South Wales Supreme Court has its own Commercial Arbitration List Judge. This covers Australia's two largest cities: Sydney is the capital of the State of New South Wales and Melbourne is the capital of the State of Victoria.

Parties can be confident that the Courts in which they appear will understand the issues and best practice for arbitration.

The new "Australian International Disputes Centre" in Sydney

The New South Wales State Government and the Australian Government have also invested, with the Australian Centre of International Commercial Arbitration and the Australian Commercial Disputes Centre, in the fitting out of a state-of-the-art arbitral centre in Sydney. Australia is now well served by several specialist rooms for the holding of arbitration with the most modern and recent being the Australian International Disputes Centre which boasts 10-custom built rooms and full business support services including case management and trust account administration.

Piper Alderman can assist you with arbitration in Australia

Piper Alderman is well placed to assist clients with international arbitration. With offices in four of Australia's largest cities: Sydney, Melbourne, Brisbane and Adelaide, we have partners who are experienced in domestic and international arbitration.

Insolvent trading – ASIC releases regulatory guide for directors

On 29 July 2010, ASIC released a guide to assist directors of Australian companies to understand and comply with their statutory duty to prevent insolvent trading. The release is particularly pertinent given the current financial climate. Dispute Resolution Partner, Tom Griffith and Corporate Lawyer, Paul Henry summarise the key points of ASIC's Regulatory Guide.

The Australian Securities and Investments Commission (ASIC) has released Regulatory Guide 217 (RG 217) to assist directors in understanding and complying with their duty to prevent insolvent trading under the Corporations Act 2001 (Cth) (the Act). It should be noted from the outset that while ASIC regulatory guides indicate ASIC's policy on specific issues, they do not have legislative force or constitute legal advice. Insolvent trading involves complex legal and accounting issues and it is therefore recommended that you seek professional advice to find out how the Act may apply to you.

When is a company insolvent?

Generally a company is insolvent when it is unable to pay all its debts when they fall due. The Appendix to RG 217 usefully lists a number of indicators of potential insolvency. These indicators include:

- the company experiencing difficulties in selling its stock, or collecting debts owed to it
- cheques being returned dishonoured, or
- legal action being threatened or has commenced against the company, or judgments entered against the company, in relation to outstanding debts.

The list is indicative only and is not exhaustive. Directors should check that list and if their company exhibits one or more of those indicators then they should investigate and obtain appropriate advice about the financial position of the company. Further, RG 217 details a number factors which ASIC will take into account (and what evidence will be considered in relation to those factors) in assessing whether a director has breached their duty to prevent insolvent trading. These factors include:

- the information the director had at their disposal to form the view that the company was solvent, and how accurate that view was; and
- whether the director monitored the financial affairs of the company and made sufficient inquiries into its financial affairs on a regular basis.

What is the duty?

The statutory duty to prevent insolvent trading is found in section 588G of the Act. Section 588G requires a director to prevent the company from incurring a debt:

- if the company is already insolvent; or
- if the company will become insolvent by incurring that debt or a range of debts including that debt,
- if at the time of incurring the debt there are reasonable grounds for suspecting that the company is already insolvent or would become insolvent by incurring that debt.

Section 588G has two levels of contravention – civil and criminal. A person commits a civil contravention where they fail to prevent the debt being incurred and they were aware that there were grounds for suspecting insolvency (or where a reasonable person in a like position would have suspected insolvency). A person commits a criminal offence where they fail to prevent the debt being incurred, and they suspected at the time that the company was insolvent or would become insolvent as a result and that the director's failure to prevent the company incurring the debt was dishonest.

Why does it matter?

Upon commission of a civil contravention, the Court may make one or more of the following orders:

- *Compensation order* – compensation payable to the company equal to the amount of the loss suffered as a result of the director failing to prevent the company from trading whilst insolvent;
- *Pecuniary penalty order* – up to AU$200,000 payable to the government if the Court finds that the director's failure to prevent insolvent trading is serious or materially prejudices the interests of the company or the company's ability to pay its creditors;
- *Disqualification from managing a corporation* – the Court may, if considered justified, disqualify a person for a period that the Court considers appropriate.

Upon commission of a criminal contravention, the Court may make one or more of the following orders:

- *Criminal penalty* – up to AU$220,000
- *Imprisonment* – up to five years.

RG 217 sets out the defences that are available to directors in response to a civil claim for insolvent trading under section 588G(2). A director has a defence, if at the time the debt was incurred, the director:

- had reasonable grounds, and did expect, that the company was solvent at that time and would remain solvent even if it incurred the debt, or a range of debts including that debt
- had reasonable grounds to believe, and did believe, that a competent and reliable person who was responsible for providing adequate information about the company's solvency was fulfilling that responsibility, and the director expected that, based on the information that person provided to the director, the company was, and would remain, solvent even if it incurred the debt, or incurred a range of debts including that debt
- because of illness or other good reason did not take part in the management of the company at that time, or
- took all reasonable steps to prevent the company incurring the debt. Matters that may be considered when determining whether this defence is made out include but are not limited to any action the director took to appoint an administrator to the company, when that action was taken and the results of that action.

ASIC's four key principles

RG 217 sets out four broad key principles which ASIC considers directors should follow to meet their obligation to prevent insolvent trading. These are:

- keeping informed about the financial affairs of the company and regularly assessing the company's solvency
- immediately, on identifying concerns about the company's financial viability, taking positive steps to confirm the company's financial position and realistically assessing the options available to deal with the company's financial difficulties
- obtaining appropriate professional advice to help address the company's financial difficulties where necessary, and
- considering advice and taking appropriate action in a timely manner.

What to do if the company is already insolvent

If a director knows, or has reasonable grounds to suspect, that the company is incurring debts that it will not be able to pay, the director is required to take all reasonable steps to prevent the company from incurring further debts. This may include:

- actively trying to persuade, in writing, the other directors to not allow the company to incur further debt,
- convening a meeting of the board to resolve that further debt not be incurred by the company, and ensuring such meeting is accurately minuted to reflect the attempt to prevent further debt being incurred,
- obtaining appropriate advice as to the options if the other directors resolve to incur further debt despite the director's dissent, or
- considering reporting the circumstances to ASIC.

Conclusion

Whilst RG 217 should not be used as a comprehensive self-help manual for directors seeking to avoid breaching their duty to prevent insolvent trading, it does provide useful guidance for such directors. The actual steps taken by a director to comply with his or her duty to prevent insolvent trading will always depend on the specific circumstances of the company, and the size and complexity of the company's business. It is important to remember that an insolvent trading claim may be brought not just by ASIC but by liquidators and creditors who may also take action against a director for failing in their duty to prevent insolvent trading. Ultimately the Court will determine whether a particular director has breached their duty to prevent insolvent trading.

Preparing for a hostile takeover

With merger and acquisition activity on the rise in Australia, one question some Australian listed companies will have to answer is "what happens if an approach is made to take us over?" James Dickson offers some answers.*

Preparation is the key to an effective response to a hostile takeover bid and increases the likelihood that shareholders will receive full value for their shares.

Companies are more likely to become targets of opportunistic takeover bids in times of volatile currency and stock markets. Bidders may seek to exploit this volatility to acquire assets at inadequate prices, in an attempt to deny target shareholders the true value of their shares.

When a hostile takeover is announced, the target is under significant pressures to respond and undertake numerous actions within very tight timeframes.

When the target receives a bidder's statement (which could be the first time the target becomes aware of the bid), the target may only have 14 days before the bidder sends its bidder's statement to the target's shareholders.

> *"The Takeovers Panel makes decisions very quickly and requires parties to make applications and responses in very short timeframes."*

During this time, the target needs to engage and brief advisers, provide its shareholders with preliminary advice, review the bidder's statement, begin preparing the target's statement, possibly engage an independent expert and respond to the bidder or apply to the Takeovers Panel to ensure that proper disclosures will be made to target shareholders.

Once the bidder's statement has been sent to the target's shareholders, the target will have only 15 days to send out its target's statement. To avoid the risk of shareholders acting only on information provided by the bidder, a target would normally work towards minimising the time between its shareholders getting the bidder's statement and when they receive the target's statement.

It is often during the first 14 days that the target feels the most pressure, particularly if it is not prepared. Target directors need specialist legal and financial advice to manage the target's response. If these specialists have not been identified and retained before the bid, it may take the target a number of days to identify them. This means valuable time is lost and the target directors would be dealing with matters without specialist assistance. This is also the case with an independent expert. An independent expert is often engaged to provide a valuation for inclusion in the target's statement. As this is a complete valuation of the target, and may require specialist valuation advice, the more time the experts have, the greater the likelihood of an accurate valuation.

Targets often need to apply to the Takeovers Panel during these first 14 days. The Takeovers Panel is Australia's primary forum for resolving disputes about a takeover bid whilst the takeover bid is underway. Targets often apply to the Takeovers Panel to require bidders to correct or expand the disclosures made in the bidder's statement. Incidentally this often delays the time at which the bidder can dispatch its bidder's statement and allows the target more time to prepare its target's statement, including any independent expert report.

The Takeovers Panel makes its decisions very quickly and requires parties to make applications and responses in very short timeframes. Preparation, again, allows targets to put forceful and persuasive arguments to the Takeovers Panel to maximise the chances of obtaining effective remedies from the Takeovers Panel.

The benefit of being prepared before a hostile takeover bid is that the directors of the target can minimise the time taken to respond fully and forcefully. This means the directors are in a better position to respond earlier, and target shareholders will have better information to make an informed decision regarding the bid.

"Target directors are under increasing scrutiny by interested parties and regulators for their actions during a takeover bid."

Target directors are under increasing scrutiny by interested parties and regulators for their actions during a takeover bid. As a result, directors may be exposed to proceedings in the Takeovers Panel during the bid and the Courts after the bid, including class actions. By being prepared, directors are more likely to act appropriately to discharge their duties.

Being prepared requires putting in place procedures that can be initiated as soon as the takeover is announced. Such procedures would involve a team of takeover response advisers being identified, briefed and regularly updated. In addition, the target would have much of its information and documentation ready in a form that can be provided to its advisers on short notice.

Targets find that being prepared before a hostile takeover bid may allow response strategies to be implemented earlier, and may increase the chances of those response strategies being successful, such as searching for a white knight or a competing bid or simply pressuring the bidder to improve its offer.

* James Dickson is a member of the Takeovers Panel, is National Head of Piper Alderman's Corporate Practice and has advised many clients in responding to hostile takeovers.

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