

Funds Management & Financial Services Alert

Demergers made easier by recent Court decisions

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Demergers often occur by way of an in specie distribution of assets or shares or units in an investment vehicle. A recent Federal Court decision has confirmed that trustees can rely on their 'natural person' powers to effect such demergers without specific approval of the trust beneficiaries.

Facts

Wellington Capital Limited (**Wellington**) is the responsible entity of the Premium Income Fund (**PIF**). The units in PIF are listed on the market operated by National Stock Exchange of Australia Limited (**NSX**).

On 5 September 2012, Wellington announced to the NSX that it had sold \$90.75 million in assets of the PIF to a newly incorporated entity called Asset Resolution Limited (**ARL**). The assets included seven mortgage loans for development projects located in Victoria, Queensland and New South Wales, \$3.764 million in cash and all of the PIF's interest in the ASIC compensation claim relating to the MFS Group (now known as Octaviar) and the proof of debt in the liquidation of two MFS Group entities.

In return for the transfer of the assets, Wellington received 830,532,768 shares in ARL which represented 100% of the issued capital in ARL. Relying on general trustee powers in the PIF's constitution, Wellington then distributed those shares to PIF unit holders on a pro rata basis in accordance with their unit entitlements. The result of the

transaction was the PIF unit holders now hold units in PIF and shares in ARL.

Wellington did not consult with or obtain the consent of the PIF unit holders to the distribution of the PIF's ARL shares to the PIF unit holders.

ASIC objected to the in specie distribution on the grounds that the constitution of the PIF did not permit it.

Decision

The PIF constitution contains very broad trustee powers. Specifically, the constitution provided that *"the Responsible Entity shall have all the powers in respect of the Scheme that is legally possible for an actual person or corporation to have and as though it were the absolute owner of the Scheme Property and acting in its personal capacity"*.

The constitution also included standard clauses relating to the method and formula for making distributions to unit holders. However, ASIC argued that these clauses only allowed for distributions to be made by cash and not in specie, and that these clauses qualified Wellington's general trustee powers.

Wellington relied on its general trustee powers as giving it the right to make the in specie distribution without unit holder consent, and that the clauses in the constitution about distributions of income did not limit these more general powers. Specifically, Wellington relied on the general trustee powers granting it the right to do whatever a company could do with the scheme's assets, and referred the court to the power of a corporation in section 124(1)(d) of the *Corporations Act 2001* (Cth) to distribute *"any of the company's property among the members, in kind or otherwise"*.

In finding for Wellington, the single judge agreed with Wellington's arguments relating to the construction of the constitution. The judge said that the lack of detailed provisions about an in specie distribution in the constitution (other than on a winding up) did not qualify Wellington's general trustee powers to do with the scheme assets whatever a corporation could do with its assets as if it were the absolute owner of those assets and acting in its personal corporate capacity. In addition, it said that when unit holders became members of PIF, they also became subject to and bound by the terms of the constitution which granted broad powers to the responsible entity. The judge said that unit holders must therefore accept the exercise of those powers.

Implications for REs

This decision confirms that broad trustee powers contained in constitutions provide a responsible entity with maximum flexibility in how it can deal with scheme assets, including by way of demerger or spin out. Even though a constitution may not include an express power to perform a particular function such as a demerger or spin out of assets, if a general power to deal with the assets exists, then the responsible entity may act in accordance with that general power. Responsible entities can also exercise general powers with the knowledge that unit holders must accept the exercise of that power, assuming it is not otherwise in breach of the constitution. The exercise of any power by a responsible entity is, of course, not unfettered: trustees must always act in good faith and in the interests of members, for example.

Relying on general powers to perform significant transactions is also not without its risks - legal and otherwise. Since the GFC, responsible entities have been criticised for relying on broadly drafted trustee powers in scheme constitutions to undertake transactions which investors have perceived as *ultra vires*. Generally, these criticisms relate to acquiring assets beyond investment mandates published in disclosure documents or investing in related funds with risk profiles that are inconsistent with the principal fund.

If you are in doubt about exercising a power under a constitution, then it is best to get a direction from a court

or a mandate from investors, assuming you can do this within your transaction timeframe. Otherwise, you are at risk of action from your investors and the regulator, and then ultimately the fate of your transaction rests with the court.

Why demerge?

In its release to the NSX, Wellington cited reasons such as accessing particular experience of entities related to ARL to manage the assets as the basis for conducting the spin out. However, there are a number of other reasons why a trust might contemplate a demerger or spin out of assets including to:

- remove underperforming investments from the trust's portfolio;
- quarantine liability;
- remove conflicts of interest;
- generate cash through the sale of the demerged entity's shares; and
- de-leverage.

If you are looking to unlock value in a trust, then you should consider a demerger or spin out. The key issues you need to consider before undertaking such a transaction are:

- whether the transaction is in the best interests of investors;
- whether your constituent documents permit the transaction to occur;
- whether you should seek court or member approval for the transaction; and
- the taxation implications for the trust and its members.

Thomsons regularly advises on corporate restructures, demergers and spin outs. Recent examples include:

- Auzex Resources Limited's demerger of its mineral exploration asset portfolio in January 2012
- McPherson's Limited's demerger of MPG Printing Limited in March 2012

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