

# SURVEYING THE STUB EQUITY LANDSCAPE POST-CAPILANO

31 January 2019 | Australia

Legal Briefings - By **Rebecca Maslen-Stannage and Alice Li**

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Reactions to the Capilano scheme of arrangement may prompt a lessening of stub equity deals involving proprietary companies, and re-emergence of the use of non-Australian stub equity vehicles.

## IN BRIEF

- Stub equity deals have become an established part of the Australian M&A landscape.
- A balance is needed between minimising bid vehicle cost and complexity, and complying with the legal requirements to offer scrip to retail shareholders.
- Early stub equity bid vehicles were companies from low regulation countries such as Bermuda or the Cayman Islands. More recently they have been Australian proprietary companies with trust structures to prevent the 50 member threshold from being crossed.
- ASIC and Court issues raised during the Capilano deal may push bidders back to foreign bid vehicles - unfortunately at likely higher cost and lesser target shareholder satisfaction.

## STUB EQUITY DEALS

Stub equity deals have become an established part of the Australian M&A landscape, because they provide target shareholders with an opportunity to retain an economic interest in the target. This interest may be:

- indirect – where target shareholders take scrip in the bid vehicle or another entity in its holding structure (e.g., Capilano Honey Limited (2018), Pepper Group Limited (2017) and Patties Food Limited (2016)); or
- direct (a ‘retained equity’ stub equity structure) – where certain target shareholders retain their existing direct shareholding in the target company (e.g., Ausenco Group Limited (2016) and Simonds Group Limited (2016)).

While the stub equity structure is not new in the Australian market, the choice of the place of incorporation for the stub equity vehicle has varied over time. Before 2011, most stub equity deals involved non-Australian stub equity vehicles, usually incorporated in low regulation countries such as Bermuda or the Cayman Islands. However, since the iProperty Group Limited (2015) transaction, we have seen an increase in the use of unlisted Australian companies.

## **CASE STUDY: CAPILANO SCHEME OF ARRANGEMENT**

In the Capilano Honey Limited scheme of arrangement (announced August 2018), a Wattle Hill / ROC Capital consortium offered Capilano shareholders the choice of cash or scrip consideration in a proprietary company (**HoldCo**). If the Capilano shareholders elected to receive scrip, they also had a right to apply for additional HoldCo shares.

There was a custodian arrangement that operated to help HoldCo remain a proprietary company. If more than 47 Capilano shareholders elected to receive scrip (not including the consortium and other substantial shareholders), their allocation of shares would instead be held by a custodian on their behalf. In this way HoldCo would remain below the 50-member threshold and not be required to convert to a public company.

### **ASIC AND COURT ISSUES**

ASIC objected to the HoldCo structure, primarily on the basis that the custodian arrangement allowed the consortium to keep the number of HoldCo members below 50, even where more than 50 target shareholders elected to receive scrip consideration. As HoldCo would remain a proprietary company, it would not need to meet the usual requirements of a public company (such as increased disclosure obligations).

The Court ultimately approved the scheme on the basis that:

- there had been at least 3 schemes which have been approved by the Courts involving “stub equity” offerings in a private equity context, including Pepper Group Limited

(2017), Patties Food Limited (2016) and Connect East Group Limited (2011);

- there was full and frank disclosure in the scheme booklet in relation to the difference between holding shares in a listed entity and holding shares in a proprietary company like HoldCo and the risks associated with holding those shares;
- the public policy basis of ASIC's concerns did not outweigh the fact that Capilano shareholders had made a commercial judgment with the benefit of full disclosure and without oppression; and
- the scheme was approved by a substantial majority and would, in any event, have been approved by more than the requisite majority without votes cast by entities which would become the substantial shareholders of HoldCo.

However, the Court was troubled by the custodian structure for a scheme where there was the potential for many minority shareholders with relatively little experience in private equity to elect scrip consideration. This suggests that if, for example, there ended up being several thousand shareholders who elected to take scrip, Court approval of a scheme may be at risk. In the Capilano scheme, 83 shareholders elected to receive scrip (representing less than 1.5% of the Capilano shares on issue). Where the line is between 50 shareholders and a problem is an unknown, which future bidders may prefer not to test.

Soon after the Court's decision, ASIC issued a media release on 13 December 2018 detailing its concern about control transactions where part or all of the consideration includes stub equity in an Australian proprietary company.<sup>1</sup> ASIC also intends to release a consultation paper in early 2019 seeking views on a proposed legislative instrument to prevent future offers which use the combined proprietary company/custodian structure. ASIC has warned that it may consider blocking individual transactions that use this type of arrangement in the interim before the consultation ends.

## **KEY ISSUES FOR A STUB EQUITY TRANSACTION**

Given the stance ASIC has taken on the Capilano scheme of arrangement, the safest route for investors offering stub equity to more than 50 shareholders may be to use a public company stub equity vehicle. This stance may also push bidders back to foreign bid vehicles. Foreign bid vehicles may not have 50 member limits, but are unfamiliar vehicles for Australian shareholders and tend to be selected for their lack of red tape and minority protections. This situation is unfortunate for Australian retail investors who may well prefer to hold a beneficial interest in an Australian vehicle over a direct interest in a foreign vehicle.

## **ENDNOTES**

1. ASIC, "[18-376MR ASIC to consult on measures to restrict offers to retail investors of sub-equity in proprietary companies](#)", 13 December 2018.

## KEY CONTACTS

If you have any questions, or would like to know how this might affect your business, phone, or email these key contacts.



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