HERBERT SMITH FREEHILLS

THE HIDDEN LEGAL RISKS IN AUSTRALIAN SUPER FUND MERGERS

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Legal Briefings – By **Michael Vrisakis, Adam Charles, Andrew Clyne, Scott Donald and Ben Plotnik**

The contemporary resurgence of super fund mergers presents a material risk of claims against directors of super fund trustees, if trustees are not undertaking appropriately sophisticated diligence exercises that take account of the complexity of modern portfolios.

IN BRIEF

• Directors of super trustees are increasingly under pressure to consider whether they need to find a merger partner in order to acquire scale.
• The complexity of modern funds means that the risk of missing implications of a merger for the asset portfolios of the merger participants is greater than ever before.
• In order to safeguard the interests of members and mitigate the risk of claims against directors, directors of super fund trustees should be insisting on sophisticated due diligence exercises.
• The processes employed in fund transfers of 10 years ago are no longer appropriate.

BACKGROUND

The pressure is on for the directors of all superannuation fund trusteesnot only to review their governance and operational arrangements in the wake of the CBA Prudential Report and the Hayne Royal Commission, but also to find a merger partner.

The complexity of contemporary superannuation funds presents an array of legal, governance, compliance and due diligence challenges, well beyond those typically faced in the successor fund transfers of ten years ago.

Accordingly, a more sophisticated diligence process should be adopted to mitigate these risks, relative to those processes adopted historically.

Trustees and directors that fail to ensure that risks are appropriately addressed via such a process are placing themselves at significant risk of a claim being made against them.

UNPRECEDENTED AND ESCALATING PRESSURE TO MERGE

Directors of super trustees are increasingly under pressure to consider whether they have the scale and business model required to provide a competitive suite of services and performance to members or whether they need to find a merger partner to acquire that scale.

The passage of *the Treasury Laws Amendment (Improving Accountability and Member Outcomes in Superannuation Measures No. 1) Act 2019* (Cth) in April, as well as APRA's evident enthusiasm for narrowing the population of entities it is required to supervise, make this question inescapable.

Reforms of the way new entrants to the system are allocated to default funds, whether those recommended by the Productivity Committee or those embedded in the now stalled Treasury Laws Amendment (Improving Accountability and Member Outcomes in Superannuation Measures No. 2) Bill 2017, or some other measure, will almost inevitably only serve to heighten that sense of urgency.

CHALLENGES PRESENTED BY THE COMPLEXITY OF CONTEMPORARY SUPER FUNDS

A new development is that the funds merging are getting larger and with that size come portfolios of increasing complexity.

Large funds today have bespoke investment arrangements across all sectors including in private equity, infrastructure, debt and hedge funds and, increasingly, direct investments and co-investments.

Some have internal management teams and many have complex intra-fund arrangements.

These bespoke arrangements bring with them an array of legal, governance, compliance and due diligence challenges well beyond those typically faced in the successor fund transfers of ten years ago.

Moreover, Australian funds are increasing allocating capital offshore, ensuring that these issues require multi-jurisdictional diligence exercises in order for the merger participants to adequately identify and address the issues.

More troublingly, it is often not until the merger is nearly consummated that the full complexity is revealed, leaving portfolio management teams, compliance officers and in-house lawyers with an avalanche of issues to address in the often hectic last few days before the merger formally takes place.

This exposes them to great risk as there’s a high chance of important details being missed.

"In-house and external lawyers must play an important part in addressing those risks, protecting the interests of members, of trustees and of the individual directors serving on the boards of those trustees."

Examples of the legal, governance and compliances issues that may arise in the context of a fund merger include:

- Material differences between the diligence processes of the merger participants when making investments, historically. These differences are often indicative of wider cultural and operational issues that should certainly be considered, and potentially addressed, pre-merger.

- Implications of the merger under legacy change of control and pre-emptive right regimes in respect of downstream asset holding structures (including in light of asset transfers that may be required in order to give effect to the merger) and the suitability of those regimes going forward.

- Legacy reporting and information rights, and confidentiality obligations, of the merger participants under downstream asset holding arrangements and the suitability of these going forward.

- Australian and foreign securities law reporting and regulatory filing obligations that may be triggered by the aggregation of asset portfolios. For example, the obligation to file substantial holding notices under the Australian Corporations Act and analogous foreign regulation.

- Implications of the merger under applicable competition, foreign investment and sector-specific regulation.

- Implications of the merger under legacy co-investment rights and the suitability of those rights going forward.

- Implications of the merger for legacy limited partner advisory committee and board appointment rights under downstream asset holding arrangements and the suitability of those rights going forward.

- Implications of the merger for legacy most-favoured-nations rights of the merger participants under downstream asset holding arrangements and the suitability of those rights going forward.
- Differences between the custodial and operational arrangements of the merger participants, for example, in relation to unit pricing, tax provisioning and reserving.

THE RISKS TO TRUSTEE DIRECTORS OF GETTING THIS WRONG

Ensuring that all the details of a portfolio's holdings, with all its complexity and inter-connectedness are understood and accounted for properly in the transition is a crucial step in any fund merger if trustees and their directors want to ensure that the best interest of members are safeguarded.

The case law on directors' duties, and the intricate set of duties created by the covenants articulated in section 52A of the *SIS Act*, make it clear that the directors must put themselves in a position to monitor actively the affairs of the trustee company.

That suggests not just the design of sophisticated management information systems to identify and track emerging risks but also genuine engagement in the process.

If cases like *ASIC v Healy* and *CBA v Friedrich* tell us anything, it is that the role of director is not ornamental, no matter on what basis the directors are appointed.

Nominee or not, expert or not, they have a duty to get across and stay across the affairs of the company.

In the case of companies acting as specialist superannuation fund trustees that means staying genuinely engaged with existential events like mergers.

That engagement must go beyond simply the composition of the merged board and the PR and member communication strategies, as important as they may be.

As the Explanatory Memorandum to the *Treasury Laws Amendment (Improving Accountability and Member Outcomes in Superannuation Measures No. 1) Act* makes clear, the superannuation funds must ensure members' interests are always paramount.

"Efficiency and investment performance are crucial, but so is risk management. And unlike taking investment risk in the markets, there is no reward for taking on due diligence risk."

WHAT TO DO?

Leave time to enable the relevant deal teams to do the analysis and work properly

There would be few easier cases to run in the current climate than a claim against a superannuation fund trustee who has failed to ensure that the valuations and investment details of the portfolio over which it has now taken responsibility were reviewed carefully, with prudence and with an eye to ensuring that the interests of the fund's members have been safeguarded.

Pay attention to the detail

Unfortunately there is no avoiding due diligence with an appropriate level of materiality. This will necessarily involve engaging suitably qualified advisers with expertise across the range of relevant Australian and foreign legal and commercial issues that may be relevant in the context of the merger.

Ensure that the process of merging the funds is overseen at an appropriately senior level

It is unrealistic, and arguably undesirable, for the directors of the trustee to be intimately involved in the detail of the process. But equally, they cannot simply assume that any problems will be 'sorted out'.

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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