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DEPOSITARY ARRANGEMENTS AND THE HEADCOUNT TEST: THE FEDERAL COURT'S DECISION IN THE TRONOX SCHEME

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Legal Briefings – By **George Durbridge**

Share depositary systems are used to enable electronic settlement of share trades and to enable shares issued in one jurisdiction to be traded in another jurisdiction. They usually work so well as to be virtually invisible. Not all of them, however, capture the necessary information about voting instructions given by the beneficial owners of shares in respect of schemes of arrangement, and perhaps of special resolutions. This article highlights some of the structural challenges that may arise dealing with share depository schemes in the context of a scheme of arrangement.

IN BRIEF

- The Court dealing with a scheme of arrangement can make orders designed to treat holders of depository interests the same as direct shareholders, as far as possible.
- The head-count test for a scheme of arrangement can, however, be partly or entirely frustrated where the scheme company's shares are held as depository interests.
- The voting instructions given by beneficial owners to a depository may be aggregated in a way which understates the "no" vote.
- These are potential problems for Australian companies with depository interests traded

overseas.

TRONOX TOP HAT SCHEME

Tronox Limited is an Australian company, listed in New York but not in Australia. Under two schemes of arrangement Tronox will redomicile, with only marginal changes in shareholding, by becoming a wholly-owned subsidiary of a company incorporated in the United Kingdom (Tronox Holdings plc or New Tronox, also to be listed on NYSE).

Under the schemes New Tronox is to issue one ordinary share in exchange for each Class A or Class B share in Tronox, so that New Tronox will have only one class of shares. Tronox has proposed one scheme of arrangement with the Class A shareholders, which are widely held, and another with Exxaro Resources, which holds the Class B shares.

The principal interest of the Class A scheme results from the fact that nearly all of the Class A shares in Tronox were held by one entity, Cede & Co (which is actually a partnership), as nominee of Depository Trust Company (DTC), on behalf of Participants, who are banks and brokers who in turn act on behalf of the ultimate beneficial owners whose interests resemble CDIs (CHESS Depositary Interests) issued under Section 13 of the ASX Settlement Operating Rules.

The decision also includes a clear and interesting discussion of the class issues raised by the Class A scheme.

VOTING MECHANISM

Under the New York law governing the DTC arrangements, neither Cede itself nor DTC may vote the shares that Cede holds. DTC receives the notice of meeting and is required to pass on copies to the Participants and to execute an Omnibus Proxy in their favour. The Omnibus Proxy reflects a current snapshot of DTC’s register and is given to Tronox and the Participants. Each Participant in turn forwards a copy of the notice of meeting to each of its clients, with a voting instruction form to be completed and returned to the Participant. The Participant must then translate the instructions it receives from its clients into aggregated votes to be cast by a proxy for the Participant.

This mechanism is effective to disclose how many votes are cast for or against the resolution. Because it aggregates the votes, however, it does not reveal how many beneficial owners of shares voted for or against the resolution. That is, it answers the question whether a 75% majority of votes was cast in favour of the scheme resolution, but not the question whether the 50% headcount test has been met.

Because Cede is only one of 393 holders of Class A shares in Tronox and the others hold less than 0.3% of the Class A shares, it was notionally possible for the scheme to be passed by an overwhelming majority of votes, but defeated on the headcount, because of votes cast by holders of a tiny minority of the shares. The Court would then have no jurisdiction to approve the scheme, unless it exercised its discretion to dispense with the headcount test. In the event, Tronox announced that its shareholders had "overwhelmingly approved" the scheme.

CLASSES QUESTIONS

There are two classes of ordinary shares in Tronox: 76.6% of the shares are Class A shares, and 23.4% are Class B shares issued to Exxaro when it sold a business to Tronox. As well as rights corresponding to those attached to the Class A shares, the Class B shares carry certain rights relevant to that sale, some of which would lapse on completion of the Class B scheme and others have been replaced in a contract between Tronox and Exxaro.

The Court accepted Tronox' submission that the schemes affected Exxaro differently from the Class A shareholders. All of the New Tronox shares to be issued under the schemes would carry the same rights, so that the shares issued to Exxaro would lack the rights which had formerly differentiated the Class B shares from the Class A shares. Exxaro would instead have contractual rights against New Tronox which replaced some of its former rights as the Class B shareholder and which the former Class A shareholders would not enjoy. Accordingly, Exxaro should be placed in a separate class from the Class A shareholders.

The Court had also to consider whether another company, Cristal Inorganic Chemicals Netherlands WA, to which Tronox had agreed to issue Class A shares for the purchase of another business, should be placed in a separate class from the other Class A shareholders. In the event, the Cristal transaction did not close before the scheme meeting.

Cristal had entered into a shareholders' agreement with Tronox, which would come into effect when the sale completed, and would lapse and be replaced by a corresponding agreement with New Tronox when the Class A scheme completed. O'Callaghan J held that Cristal's rights under the new agreement corresponded so closely with those under the old agreement that the change in Cristal's rights under the agreements which would result from the scheme would not materially affect the position of Cristal vis-à-vis the other Class A shareholders, so it was not class-creating.

In addition, Cristal had undertaken to Tronox to vote in favour of the Class A scheme, if the transaction had closed before the scheme meeting. Since Cristal received no consideration for this undertaking, O'Callaghan J held that it was not class-creating.

ORDERS FOR CLASS MEETINGS

As usual, the Court made orders as to how the explanatory memorandum was to be distributed and the Class A scheme meeting held. In this matter, those orders had to reflect the fact that the beneficial owners of the great majority of the Class A shares could only vote indirectly through their respective Participants and the Omnibus Proxy. They:

- do not attempt to treat the ultimate beneficial owners of the shares as members of Tronox for voting purposes (although they allow for a beneficial owner to attend and vote, under a proxy provided by their Participant);[1]

- require Tronox to send copies of the explanatory memorandum to all of its members 21 days before the date of the scheme meeting. Although DTC will receive these documents instead of most of the beneficial owners of the Class A shares, the Court relied on DTC's obligations under US law to pass them on to the Participants, for them to pass on to the beneficial owners;

- recognise DTC's snapshot of its register at the record time as fixing the number of shares in respect of which each Participant is entitled to vote and the Omnibus Proxy as conferring on the Participant the power to vote the shares;

- provide for Participants to attend the meeting by proxy and for the quorum to be determined by reference to the shares credited to those Participants in the DTC snapshot;

- for the purposes of a poll, treat any votes cast at the meeting in accordance with the DTC system as having been cast by Cede & Co.

In effect, they adopt the DTC system for distributing the notice of meeting and for gathering proxies as effective for the purposes of the meeting.

The Court also ordered a meeting of the Class B shareholders. Since only Exxaro holds Class B shares, and it holds them directly, the Court directed that the meeting be held by Exxaro's attorney or representative signing a minute of the resolution.

THE HEADCOUNT TEST

As noted above, the aggregation of votes in the DTC system will tend to obscure the number of beneficial owners who have directed that their votes be cast for or against the scheme. Even if a Participant attends the scheme meeting to cast votes for its clients, it will often have to vote both for the resolution (on behalf of some clients) and against it (on behalf of others). In that case, both votes are disregarded.[2] Accordingly, it may be impossible to apply the headcount test in any sensible way.

In 2007, the Court was given power to dispense with the headcount test.[3] Tronox has foreshadowed a possible application to the Court to exercise this power when it applies to the Court for approval of the scheme. There is no precedent for such an order, and the basis for making one has not been clearly made out. O'Callaghan J mentioned that courts have contemplated making dispensing orders in cases which resembled Tronox in that the numbers of beneficial owners who directed their votes for and against the scheme might be obscured because the beneficial owners were represented by nominees. Those orders do not appear to have been made.[4]

The dispensing power was given after a matter in which it appeared that attempts had been made to manipulate the headcount test by share-splitting. Share-splitting is mentioned in the Explanatory Memorandum for the amending legislation, but the power is not limited to similar cases. In *Boart Longyear*, Farrell J said that:

> "… the Court is entitled to take into account any form of manipulation in determining whether the headcount achieved at a scheme meeting accurately reflects the will of shareholders"

and

> "… the headcount test is designed to protect the interests of minorities by providing a check on the ability of creditors with large claims or members with large shareholdings to carry the day. Accordingly, it is appropriate that the Court's discretion to dispense with it should be rarely used."[5]

For a more detailed discussion on the *Boart Longyear* matter, see our earlier article.

That is, it is a wide power, but one to be exercised with severe restraint. In the circumstances of that case, her Honour held that it would not be appropriate to exercise the dispensing power to override the small shareholders' votes when the evidence fell short of showing that the majority against the scheme had been brought about by circulation of misleading information (share-splitting and nominees were not in issue).

If the Court is satisfied that the headcount test would have been satisfied, but for share-splitting, it seems clear that the Court should dispense with the headcount. It should make no difference that the headcount is obfuscated by an opaque depository system, rather than by mischief-making. But only if the Court can be satisfied that the headcount test would otherwise have been satisfied. How is the Court to be satisfied that it would, except by extrapolating from a hefty majority of votes? Indeed, how is the Court to be satisfied that the depository system has not concealed from it a failure to satisfy the headcount test?

This problem is not new: Barrett J pointed out in 2010 that "there is substance in the criticism" that the head count test "disenfranchises investors who choose to invest through nominees or depository arrangements".[6]

Tronox noted that, if the scheme was approved by the requisite 75% voting threshold but failed the head count test, it would likely at the final Court hearing seek an order from the Court dispensing with the head count test. As events transpired, the Court approved the scheme on 22 March 2019. The Court did not make an order dispensing with the head count test as the schemes satisfied both statutory approval tests.

DISTORTING THE VOTES?

In addition to masking the headcount and the turnout, a depository system may distort the votes cast on a poll on a resolution to approve a scheme of arrangement, or wherever a majority greater than 50% is required. When the votes are aggregated, they often have to be netted out. If the depository can appoint only one proxy to vote on a resolution, it must net out the votes which it has been directed to cast for the resolution against the votes which it has been directed to cast for the resolution, and direct the proxy to cast the net votes for or against the resolution. If the depository nets the votes on a 1:1 basis, it will distort their effect on a super-majority vote.

Assume that a scheme company has 100 shares on issue and holders of 60 of the shares vote for the scheme and holders of the remaining 40 shares vote against it: the scheme will fail with a 60% majority. Assume instead that all 100 shares are held by a depository, who nets out the voting instructions and votes 20 shares in favour of the scheme: it will be passed, with 100% of a small turnout.

Section 249X of the Corporations Act allows a depository, as a member of a company who can cast two or more votes, to appoint two proxies and specify how many votes each proxy may exercise. Whether this will prevent netting from distorting the votes cast for a depository at a meeting of an Australian company will depend on the depository's own rules, and the procedures under which voting instructions are communicated to the depository.

The ASX Settlement Operating Rules require the CHESS depository to appoint two proxies whenever it is able to do so. The CHESS depository, however, in general holds shares in foreign companies, to which section 249X of the Corporations Act will not apply, and to which no corresponding laws of the places of formation may apply.

ENDNOTES

1. This seems to be possible, although unusual, under the DTC system. It was allowed for by orders made by Davies J in *Re Plantic Technologies Ltd* [2010] VSC 484 – Plantic had a London listing, and 80% of its shares were represented by depository receipts.

2. *Re Spark Infrastructure No. 1 Ltd* [2010] NSWSC 1497 at [20]-[28], per Barrett J.

3. *Corporations Amendment (Insolvency) Act 2007* (Cth), inserting "unless the Court otherwise orders" into subparagraph 411(4)(a)(ii)(A), the headcount test.

4. *Re Plantic Technologies Ltd* [2010] VSC 484 at [16], *Re Plantic Technologies Ltd (No. 2)* [2010] VSC 554 (no mention of dispensing in reasons for approval), *Re pSivida Ltd* [2008] FCA 627 at [11]-[12].

5. *Re Boart Longyear Ltd* [2019] FCA 62 at [159] – [160]. This is not the 2017 debt-to-equity scheme, but a subsequent top hat scheme which passed on the votes but was defeated by small shareholders on the headcount.

6. *Re Spark Infrastructure Holdings No. 1 Ltd* [2010] NSWSC 1497 at [29].

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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