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Delaware Chancellor Throws Gauntlet for Delaware Supreme Court to Address Appraisal Rights of Beneficial Holders

By David Graff and Rachael Kierych

Delaware's current regulatory landscape creates significant issues for beneficial holders of stock seeking to exercise appraisal rights in corporate mergers. Although Delaware's appraisal statute was designed to allow dissenting shareholders to seek compensation and a fair value determination of their shares, a recent ruling in *In re Appraisal of Dell Inc.* illustrates that Delaware law in its current state conflicts with these appraisal principles in the context of beneficially held shares.¹ In accordance with Delaware precedent, Vice Chancellor Travis J. Laster granted a motion by Dell for summary judgment thereby denying appraisal to several funds that held Dell in street name. The initial appraisal demand was caused by the record holder of the funds' shares, Cede & Co. Subsequently, the funds' custodial banks

instructed Dell's transfer agent to issue the certificated shares in the name of the custodial banks' nominees, rather than Cede. Because the shares were retitled post-demand, the court held that the petitioning funds did not satisfy Delaware's continuous holder requirement and therefore denied appraisal.

The Paper Problem, Federal Reformation & Share Immobilization via Depositories

Current limits to shareholders' right of appraisal are an unintended consequence of decades-old reforms in the processing of stock transactions. Until the early 1970s, shares of stock were transferred using a physical certificate-based system facilitated primarily via negotiation wherein stock owners endorsed physical certificates to respective assignees.

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“Each time securities were traded, the physical certificates had to be delivered from the seller to the buyer, and in the case of registered securities the certificates had to be surrendered to the issuer or its transfer agent for registration of transfer.” *In re Dell*, at *8 (citation omitted). As trade volume increased, so did the number of physical certificates and the transfer and processing of each certificate. *See id.* “By the late 1960s the paperwork burden reached ‘crisis proportions[.]’” and led to significant losses. *See id.* at *12 (citations omitted).

When broker dealers could no longer maintain the certificate system due to increased volume of transactions, Congress passed the Securities Investor Protection Act of 1970 that instructed the Securities and Exchange Commission to examine the crisis. 15 U.S.C. §§ 78kkk(g). The SEC then suspended physical transfer of certificates,² adopted a depository system, and constructive delivery of securities held in “street name” emerged. 15 U.S.C. § 78aq-1(e). “Trading at current levels is only possible because of share immobilization and DTC.” *In re Dell*, at *11 (citations omitted).

Constructive delivery is facilitated via share immobilization and indirect holding wherein physical certificates are issued. The certificates are not held by beneficial owners, but “are immobilized³ with a clearing corporation, and registered in the clearing corporation’s name.” In 1973, the New York Stock Exchange created the Depository Trust Company, a clearing agency and depository that tracks the ownership interests of its members — the intermediaries — but does not identify the names of beneficial owners. Under this system, ultimate beneficial owners do not have direct relationships with issuers and alternatively hold entitlements through intermediaries. Because the DTC holds intermediaries’ shares in fungible bulk, shares are not issued in participants’ names. Instead, shares are issued in street name with legal title remaining with Cede.

The Problem: Delaware’s Strict Interpretation Of “Continuous Holder” & “Record Holder”

Delaware is home to more corporations than people.⁴ In fact, more than 50 percent of

U.S. publicly traded companies, and approximately 64 percent of the companies listed in the Fortune 500⁵ are incorporated in the small state of Delaware.⁶

Beneficial holders of stock therefore face challenges under Delaware law as no individual or entity other than the record holder may demand appraisal under Section 262. 8 Del. C. § 262(a); *see Transkaryotic Therapies*, at *3.^{7,8} Record holders “bear[] the ultimate burden of establishing [their] right to appraisal.” *Id.* (alteration in original) (citing *Schneyer v. Shenandoah Oil Corp.*, 316 A.2d 570, 573 (Del. Ch. 1974)). To meet that burden, record holders must make written demand for appraisal prior to the shareholder vote on the public mergers and acquisitions transaction. 8 Del. C. §§ 228, 262(a); *Transkaryotic Therapies*, at *3. Under Delaware law, record holders may seek appraisal for shares that are (1) owned on the date of the statutorily compliant demand for appraisal; (2) held continuously through the effective date of the public M&A transaction (the “Continuous Holder Requirement”); and (3) not voted in favor of nor consented in writing to the public M&A transaction. *See* 8 Del. C. §§ 228, 262(a); *In re Ancestry.com Inc.*¹⁰ If all three prongs are satisfied, the record holder has an unqualified right to the judicially determined fair value of its stock. 8 Del. C. §§ 228, 262(a); *Transkaryotic Therapies*, at *3. The recent *In re Dell* decision highlights the issues beneficial holders face with respect to the strict interpretation of Section 262, particularly prong two, the continuous holder requirement.

Proposed Solutions

Delaware’s appraisal statute was designed to provide shareholders compensation “for the loss of the[ir] veto power” in corporate decisions “and to give dissenters the right to demand fair value of shares.”¹¹ Delaware law in its current state conflicts with these appraisal principles by creating hurdles for beneficial holders. Proposed solutions and mechanisms to cope with these issues are detailed below.

1. Legislative Amendment

To ensure that beneficial holders maintain appraisal rights, 8 Del. C. § 262 should be amended. First, the statute should be amended to comport

with the federal appraisal statute.¹² Cede is not a record holder under federal law. 15 U.S.C. § 78c(23)(A). Rather, holders of record are the DTC participants. 17 C.F.R. §240.14c-1(i). Consistent with the 2003 legislative amendments to include the Cede Breakdown¹³ as part of the stocklist, 8 Del. C. § 219(c), and to entitle stockholders to obtain a “Cede breakdown” as part of the stocklist sought under section 220, *id.* at § 220, Delaware’s legislature should amend the appraisal statute to include DTC participants listed on Cede breakdowns in its definition of record holder.

Precedent dictates that the Cede breakdown is part of the corporate stock ledger for purposes of establishing voting rights under Delaware law. 8 Del. C. § 219(c); *Kurz*, 989 A.2d at 175.¹⁴ Thus, intermediaries enumerated on the Cede breakdown may act as record holders and vote shares held in street name. *See id.* Since a Cede breakdown is part of a corporate stock ledger in the shareholder voting context,¹⁵ DTC participants listed on the Cede breakdown should also be considered part of the stock ledger for purposes of establishing appraisal rights. *See* 8 Del. C. § 262(a). DTC participants would thus be record holders, retitling shares before the transaction’s effective date would be continuous holding, and stockholders would maintain their appraisal rights. As stated by Vice Chancellor Laster, “‘stockholder[s] of record’ [should] include[] the custodial banks and brokers listed on the DTC participant list.” *In re Dell*, at *78 (alteration in original).

2. Judicial Intervention

The Delaware court’s role is to interpret the statutory language of the General Assembly. As stated by the Delaware Supreme Court and reiterated in *In re Dell*, “[i]n our constitutional system, this court’s role is to interpret the statutory language that the General Assembly actually adopts, even if unclear and explain what we ascertain to be the legislative intent without rewriting the statute to fit a particular policy position.”¹⁶ Given the strong presumption for judicial interpretation of statutory law and the ambiguous nature of § 262, the judiciary is urged to comport with federal law and interpret § 262 to be inclusive of beneficial holders.

3. How Beneficial Shareholders Can Protect Themselves in the Current Climate

“DTC has been estimated to hold ‘about three-quarters of [the] shares in publicly traded companies.’ ” *In re Dell*, at *10. Beneficial holders can ensure that they will have the right to a judicial determination of the fair value of their shares by either (1) prompting the record holder to make a demand for appraisal, or (2) retitling shares held in street name prior to the deadline for an appraisal. Those who seek to exercise appraisal rights via demand through their custodian should only utilize the services of banks and brokers that do not have internal regulations, mandating that certificates be retitled in the names of their own respective nominees. Accordingly, the original nominee for shares held in street name, such as Cede, would remain the holder of record throughout the applicable timeframe.

Alternatively, in the event of retitling, before a beneficial holder may demand appraisal, the beneficial holder must first ensure that they are also the record holder. *See Transkaryotic Therapies*, at *3 (“the record holder’s actions determine perfection of the right to seek appraisal[]”). To be deemed both a beneficial and record holder, an investor should transfer securities to facilitate the retitling, irrespective of whether the shares are held as physical certificates or in street name. Such retitling may be facilitated by working with the respective broker-dealer and/or transfer agent. ▲

ENDNOTES

¹ *In re Appraisal of Dell Inc.*, Consol. C.A. No. 9322-VCL, 2015 Del. Ch. LEXIS 184 (Del. Ch. July 13, 2015) (“*In re Dell*”).

² 17 CFR § 17(A)(e).

³ “The shares of each company held by DTC are typically represented by one or more ‘immobilized’ jumbo stock certificates held in DTC’s vaults.” *In re Dell*, at *15 (citation omitted).

⁴ Michael Magnusson, *Offshore Companies* 19 (Opus Operis LLP 2013).

⁵ This year’s “Fortune 500 companies account for \$12.5 trillion in revenues, \$945 billion in profits, \$17 trillion in

market value[,] and employ 26.8 million people worldwide.” See *Fortune 500*, *Fortune*, <http://fortune.com/fortune500/> (last visited Aug. 12, 2015). The top five (5) Fortune 500 companies are Walmart, Exxon Mobil, Chevron, Berkshire Hathaway and Apple. Of those five (5) companies, three (3) are incorporated in Delaware.

⁶ *About Agency*, State of Delaware, <http://corp.delaware.gov/aboutagency.shtml> (last visited Aug. 19, 2015); Christopher Wink, *64% of Fortune 500 Firms are Delaware Incorporations* (Sept. 23, 2014, 10:11 AM), <http://technical.ly/delaware/2014/09/23/why-delaware-incorporation/>.

⁷ *In re Appraisal of Transkaryotic Therapies Inc.*, No. Civ. A. 1554-CC, 2007 WL 1378345, at *3 (Del. Ch. May 2, 2007) (“*Transkaryotic Therapies*”).

⁸ See, e.g., *Bandell v. TC/GP Inc.*, No. 247, 1995, 1996 Del. LEXIS 23, 1996 WL 69789 (Jan. 26, 1996); *Enstar Corp. v. Senouf*, 535 A.2d 1351, 1356 (Del.1987); *Neal v. Ala. By-Products Corp.*, Div. Action No. 8282, 1988 Del. Ch. LEXIS 135, at *2, 1988 WL 105754 (Oct. 11, 1988).

⁹ Federal reformation and share immobilization has made Cede the record holder for beneficially owned shares.

¹⁰ *In re Ancestry.com Inc.*, Consol. C.A. No. 8173-VCG, 2015 WL 66825, at *4 (Del. Ch. Jan. 5, 2015) (“*Ancestry.com*”).

¹¹ *Transkaryotic Therapies* at *3. “Thus, the primary purpose of § 262 is to protect the contractual rights of shareholders who object to a merger and to fully compensate shareholders for any loss they may suffer as a result of a merger.” *Id.* (citing *Root v. York Corp.*, 39 A.2d 780 (Del. Ch. 1944); *Weinberger v. UOP Inc.*, 457 A.2d 701, 714 (Del. 1983)).

¹² 15 U.S.C. §§ 78 et seq.

¹³ A DTC “Cede breakdown” is a company-specific listing of shares held by intermediaries such as banks and brokers on behalf of their clients.

¹⁴ *Kurz v. Holbrook*, 989 A.2d 140, 175 (Del. Ch. Feb. 9, 2010) *aff’d in part, rev’d in part sub nom. Crown EMAK Partners, LLC v. Kurz*, 992 A.2d 377 (Del. 2010).

¹⁵ 8 Del. C. § 219(c); *Kurz*, 989 A.2d at 175.

¹⁶ *In re Dell*, at *36 (quoting *Taylor v. Diamond State Port Corp.*, 14 A.3d 536, 542 (Del. 2011)); see also *In re Dell*, at *36 (quoting *Crown EMAK Partners, LLC v. Kurz*, 992 A.2d 377, 398 (Del. 2010)) (“The DGCL is a comprehensive and carefully crafted statutory scheme that is periodically reviewed by the General Assembly.”).

About Anderson Kill

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