

WHO OWNS STOCK IN A DELAWARE CORPORATION? THE ANSWER CAN BE A SURPRISE

by S. Michael Sirkin

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On July 13, the Delaware Court of Chancery granted summary judgment against five appraisal petitioners¹ in the *Dell* appraisal action because they unwittingly violated the “Continuous Holder Requirement” in Section 262(a) of the DGCL.² The Petitioners did not elect to sell “their” shares, but record ownership changed hands in banal, back-office transactions between the time they demanded appraisal and the closing of the merger. This violated the requirement that the record owner of shares for which appraisal is sought must “continuously hold[] such shares through the effective date of the merger or consolidation,”³ thereby destroying the Petitioners’ rights to seek appraisal.

Vice Chancellor J. Travis Laster lamented the result and encouraged the Supreme Court to reverse his decision and the binding precedents that constrained him.⁴ As a result, an appeal would seem likely.

This decision marks the third time this year that the Court of Chancery has addressed the mechanics of securities intermediaries and the execution of modern-day securities transactions.⁵ It comprehensively explores how the system developed and how Delaware corporate law applies to it. The decision also

explores the potential benefits of a different approach going forward.

The Court of Chancery’s Holding: Settled Law Applied to a Simple Set of Facts

The relevant facts appear deceptively simple. The Petitioners were beneficial owners of Dell common stock. More precisely, they were “entitlement holders”⁶ that held shares through custodial banks. The custodial banks were themselves “entitlement holders” that held shares through Cede & Co., as the nominee of the Depository Trust Company. Cede was therefore the stockholder of record for the Petitioners’ shares on the corporation’s stock ledger.⁷

When the Petitioners sought appraisal, DTC removed the requisite number of shares from its undifferentiated “fungible bulk” of Dell shares, and caused Dell’s transfer agent

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to issue paper stock certificates in Cede's name. DTC delivered these certificates to the Petitioners' custodial banks. The custodial banks, however, have internal policies against holding stock certificates in the name of anyone other than their own nominees. Accordingly, the custodial banks instructed Dell's transfer agent to issue new certificates in the name of the custodial banks' nominees. The transfer agent complied, thereby replacing Cede on the corporation's stock ledger with the nominees of the Petitioners' custodial banks.⁸

Were it not for the appraisal action, this last step would seem innocuous. But the transfers of record ownership from Cede to the nominees of the custodial banks occurred before the effective date of the merger, and thereby violated Section 262(a), which requires that the "holder of record stock in a corporation" must "continuously hold[] such shares through the effective date of the merger" giving rise to the appraisal claim. Because longstanding Delaware Supreme Court precedents have confined the "holders of record stock in a corporation" to the names that appear on the corporation's stock ledger, Vice Chancellor Laster concluded that he had no choice but to grant Dell's motion for summary judgment.⁹

"The Possibility of a Different Approach"

After tersely applying settled law to the facts, the bulk of the decision advanced "the possibility of a different approach"¹⁰ for Delaware law. Specifically, the decision argued that the Supreme Court should redefine the statutory term "stockholder of record" to include DTC participants—*i.e.*, custodial banks and brokers. In support of his position, the Vice Chancellor's opinion dove deeply into the murky waters of the administration and execution of securities transactions, and explored their misunderstood history.

The Paper Era

Until at least the mid-1960s, securities transactions were quaint and relatively direct. Buyers and sellers negotiated deals, and sellers endorsed physical certificates to the name of an assignee, who was typically a broker. The corporation was notified and instructed to record a change in ownership.

It was during this era that the Delaware Supreme Court held, for purposes of the appraisal statute, that "only the registered holder of stock is a 'stockholder.'" ¹¹ The Court observed that appraisal is a legal right, as opposed to an equitable one, and reasoned that a corporation was entitled to rely on its

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own records to promote “order and certainty.”¹² As a result, if a stockholder chose to complicate its relationship to the corporation by holding through an intermediary, she did so at her own peril, and the corporation was not obliged to look through the record holders of shares.

In the years that followed, the rule of *Salt Dome* remained the law of Delaware. The Delaware Courts continued to apply it, and even expanded the rule, holding in 1966 that a corporation was required “to confine itself to dealing with registered stockholders in intra-corporate affairs.”¹³ Accordingly, what had been framed in 1943 as a permissive safe harbor was reframed as a rigid requirement in 1966. The very next year, the rule was codified into statutory law, finding its way into the modern form of Section 262.¹⁴

The Federal Policy of Share Immobilization

As transaction volume increased, the paper piled up. In 1970, the federal government intervened to ease the paperwork crisis that was gumming up the securities markets.

“Congress responded by passing the Securities Investor Protection Act of 1970, which directed the SEC to study the practices leading to the growing crisis in securities transfer.”¹⁵ At the SEC’s recommendation, “Congress then passed the Securities Acts Amendments of 1975, which directed the SEC to ‘use its authority under this chapter to end the physical movement of securities certificates in connection with the settlement among brokers and dealers of transactions in securities consummated by means of the mails or any means or instrumentalities of interstate commerce.’ ”¹⁶ In light of the developing federal policy of share immobilization, the members of the New York Stock Exchange formed DTC to facilitate the end of the movement of physical stock certificates.

Today, DTC holds “about three-quarters of [the] shares in publicly traded companies.”¹⁷ Cede is the recognized owner of record of these shares under Del-

aware law. This modernized system facilitates the average current daily volume of approximately one billion shares.

A New Policy Debate

In light of this history, should Delaware law continue to treat the chain of ownership the same way it did in the paper era, or should the Delaware law embodied in *Salt Dome*, *Olivetti*, and Section 262(a) be revisited?

In dicta in *Dell*, and in *Kurz v. Holbrook*¹⁸ five years ago, Vice Chancellor Laster argued that it should. In his view, too many of the empirical assumptions that underlay *Salt Dome* and its progeny were either incorrect when they were made or have become incorrect with the passage of time and the advent of federally mandated share immobilization. In *Dell*, Vice Chancellor Laster extolled the virtues of a more flexible system that would permit a corporation to rely on its stocklist (as is now required), but would not bestow talismanic properties on the stocklist. Intricate questions of stock ownership that arise in litigation could be subject to proof in case-by-case adjudication.¹⁹

Practical Implications of the Proposed New Approach

The “different approach” to record ownership discussed in *Dell* does not look like much. Corporations would be permitted (but not required) to look only one layer beneath Cede to the nominees of DTC’s participant banks and brokers. In *Dell*, and in *Kurz* before it, the Court of Chancery has previewed what practical effect this new approach might have.

Information Flow: Mechanically, this level of ownership information is already available to issuing corporations upon request from DTC for use in tabulating stockholder votes,²⁰ so information flow is unlikely to pose problems.

Appraisal Arbitrage: Under the current regime, any stockholder who buys shares after the merger is ap-

proved on the open market can lay claim to having purchased non-approving shares from Cede's "fungible bulk" and seek to have those shares appraised, without regard to how a selling stockholder may have voted the shares. As a result, appraisal arbitrageurs have been permitted to seek appraisal for shares held of record by Cede at least so long as the aggregate number of shares seeking appraisal does not exceed the aggregate number of shares held by Cede in its fungible bulk that were not voted in favor of a merger.²¹

As the *Dell* opinion is careful to note, looking through DTC to its participant banks and brokers would not destroy the practice of appraisal arbitrage, but it would potentially limit the pool of shares available for arbitrage activity. If the corporation can look through DTC—with record ownership of approximately 75% of publicly held shares—to hundreds of banks and brokers holding smaller pools of shares, an appraisal arbitrageur may have a more difficult time amassing a large position of "dissenting" shares after the vote, and will have to either buy before the record date or buy proxies along with their shares. Again, this would be unlikely to halt appraisal arbitrage altogether, but might make it more difficult and, on the flip side, might reduce the exposure to post-closing appraisal litigation that acquirors have to contend with.

Books and Records: The proposed change would not affect stockholders' access to a corporation's stocklist. Under Section 220 of the DGCL, a stockholder who requests a stocklist has long been entitled to a "Cede breakdown" that shows the corporation's stock ownership at the level of the DTC participant banks and brokers.²²

Counting Stockholders: A change in the law of the type contemplated in *Dell* would affect the sheer number of record stockholders. Under Section 203(b)(4), a corporation is exempt from Delaware's antitakeover statute if it has fewer than 2,000 record

stockholders.²³ Likewise, under the "market-out exception" in Section 262(b)(1), there are no appraisal rights available "for the shares of any class or series of stock, which stock . . . at the record date fixed to determine the stockholders entitled to receive notice of the meeting of stockholders to act upon the agreement of merger or consolidation, [was] either (i) listed on a national securities exchange or (ii) held of record by more than 2,000 holders."²⁴ There are therefore at least two provisions of the DGCL, however rarely they are implicated, that key off of the number of record stockholders, and the "different approach" advocated in *Dell* would effect that count.

ENDNOTES:

¹The widely publicized management-led buyout of Dell, Inc. generated many appraisal petitioners whose entitlement to seek appraisal was not at issue on summary judgment. For simplicity, this article will refer to the five petitioners against whom summary judgment was granted as the "Petitioners."

²See generally *In re Appraisal of Dell Inc.*, 2015 WL 4313206 (Del. Ch. July 13, 2015) (hereinafter, "*Dell*").

³8 *Del. C.* § 262(a); see also *Nelson v. Frank E. Best Inc.*, 768 A.2d 473, 477 (Del. Ch. 2000) ("Bear Stearns was transferring the Disputed Shares to Mitchell Partners' name. As a result, Cede's demand was invalid, because Cede would not 'continuously' be the holder of record between the March 9 date of Cede's demand and the effective date of the Merger, as is required by 8 *Del. C.* § 262(a).")

⁴*Dell*, at *3 ("Delaware cases simply treated Cede as the holder of record and applied the Continuous Holder Requirement strictly. Under these decisions, the motion must be granted. A different approach is possible and, in my view, preferable.")

⁵See *In re Appraisal of Ancestry.com, Inc.*, 2015 WL 66825 (Del. Ch. Jan. 5, 2015); *Merion Capital LP v. BMC Software, Inc.*, 2015 WL 67586 (Del. Ch. Jan. 5, 2015).

⁶See 6 *Del. C.* § 8-102(a)(7) (defining "entitlement holder" as a "person identified in the records of a securities intermediary as the person having a security entitlement against the securities intermediary").

⁷*Dell*, at *7.

⁸*Id.* at *7-8.

⁹*Id.* at *3 (“But that is not how our cases have interpreted the statutory term, and this court is bound by those precedents. Dell’s motion for summary judgment is therefore granted.”).

¹⁰*Id.* at *10.

¹¹*Id.* at *16 (quoting *Salt Dome Oil Corp. v. Schenck*, 41 A.2d 583, 589 (Del. 1945)).

¹²*Salt Dome*, 41 A.2d at 589.

¹³*Dell*, at *17 (citing *Olivetti Underwood Corp. v. Jacques Coe & Co.*, 217 A.2d 683, 686-87 (Del. 1966)).

¹⁴*Id.* at *17-18.

¹⁵*Id.* at *5 (citing 15 U.S.C. § 78kkk(g)).

¹⁶*Id.* at *5 (citing 15 U.S.C. § 78q-1(e)).

¹⁷*Id.* at *6 (quoting Larry T. Garvin, *The Changed (And Changing?) Uniform Commercial Code*, 26 FLA. ST. U. L. REV. 285, 315 (1999)).

¹⁸989 A.2d 140 (Del. Ch. 2010), *aff’d in part, rev’d on other grounds sub nom. Crown EMAK P’rs, LLC v. Kurz*, 992 A.2d 377 (Del. 2010).

¹⁹*Dell*, at *24-25.

²⁰*Kurz*, 989 A.2d at 173-74; *see also, e.g.*, Handbook for the Conduct of Shareholders’ Meetings 40 (ABA Business Law Section, Corporate Governance Committee ed., 2000).

²¹*See generally Ancestry.com*, 2015 WL 66825; *BMC Software*, 2015 WL 67586; *In re Appraisal of Transkaryotic Therapies, Inc.*, 2007 WL 1378345 (Del. Ch. May 2, 2007).

²²*Kurz*, 989 A.2d at 171-72 (“There is ample precedent for treating the Cede breakdown as part of the stock ledger. Some thirty years ago, when the depository system was still new, this Court held that a stockholder was entitled to a Cede breakdown under Section 220 when the stockholder asked for a stocklist.”) (citing *Hatleigh Corp. v. Lane Bryant, Inc.*, 428 A.2d 350 (Del. Ch. 1981) and *Giovanini v. Horizon Corp.*, 1979 WL 178568 (Del. Ch. Sept. 10, 1979)).

²³8 Del. C. § 203(b)(4) (“The restrictions contained in this section shall not apply if . . . [t]he corporation does not have a class of voting stock that is: (i) Listed on a national securities exchange; or (ii) held of record by more than 2,000 stockholders . . .”).

²⁴8 Del. C. § 262(b)(1).

CHANGE-OF-CONTROL PROTECTIONS IN SIGNIFICANT NON-DEBT COMMERCIAL AGREEMENTS: THE IMPORTANCE OF A “DEAD HAND” PROVISION

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Parties to significant commercial agreements may not currently be well protected against the risk of being forced to continue to partner with a counterparty after a change in control of the counterparty’s board (for example, through a proxy contest).

Change-of-control protections can be especially important in certain commercial agreements—such as a major joint venture, critical supplier or key product licensing agreement—where the company’s counterparty has been selected based on factors such as the ability to collaborate and to execute; trustworthiness in the marketplace; a compatible corporate culture; competitive position; and other similar factors. Through these provisions, companies seek to protect themselves against involuntarily having to partner with, for example, their competitors; shareholder activists who may have an agenda inconsistent with the objectives of the venture; or other parties that the company would not want to partner or collaborate with, rely on, or share its intellectual property with.

Accordingly, these types of agreements routinely include a right of the company (and/or its counterparty) to change the terms, obtain additional rights, or terminate the agreement upon a change of control of