

Dell Stockholders Lose Appraisal Rights As Custodial Bank's Common Back-Office Procedures Result in Technical Failure of Continuous Holder Requirement

In *In re Appraisal of Dell* (July 13, 2015), Vice Chancellor Laster, stating that he was compelled by Delaware Supreme Court precedent, applied a “strict” interpretation of the “Continuous Holder Requirement” of the Delaware appraisal statute. The Vice Chancellor, granting summary judgment in favor of Dell, Inc., held that the funds seeking appraisal of almost one million Dell shares (acquired by them after announcement of the Dell going-private transaction) had not met the Continuous Holder Requirement and so had lost their right to appraisal.

Key Points

- **Court's “strict” interpretation of Continuous Holder Requirement.** Following standard procedure, after the appraisal petition was filed, The Depository Trust Company (DTC) transferred the shares owned by the funds to the funds' custodial banks. As is not uncommon, the banks changed the name of the record holder of the shares from Cede & Co. (DTC's nominee) to the banks' nominees. The Vice Chancellor ruled that the name change caused a change in the record ownership of the shares. The Vice Chancellor characterized the result as not reflecting the “reality” that the beneficial owners of the shares had remained unchanged and should have been entitled to appraisal rights. The result was compelled, however, according to the Vice Chancellor, by Delaware Supreme Court precedent that, under these circumstances, treats Cede for all purposes as the record holder (without “looking through” Cede or considering the beneficial owner's custodial bank as being in the same position as Cede), as well as the Supreme Court's emphasis on the need for “strict construction” of the appraisal statute requirements.
- **Immediate impact on appraisal rights.** The decision may immediately affect stockholders' access to appraisal rights. Companies, stockholders, and custodial banks and brokers should evaluate the impact of the decision on their current situations.
- **Court's suggestion that the Supreme Court overrule the holding and adopt a different approach.** We expect that the decision will be appealed to the Delaware Supreme Court. We note that, under *Dell* as it now stands, whether shareholders in exactly the same substantive position will or will not be entitled to appraisal rights will be based on (i) the technical record ownership requirements under Delaware law (which are based on precedent from appraisal cases that pre-date the federally mandated depository system of share ownership and which are inconsistent with how record ownership is determined under federal law) and (ii) the vagaries of the back-office procedures

of the custodial bank or broker involved (such as whether the bank stores paper stock certificates in its own vault or the DTC's vault and whether the certificates stored in the bank's vault must be in the name of the bank's own nominee). In the decision, Vice Chancellor Laster advocated that the Supreme Court adopt a new approach (which would be consistent with federal law) to "look through" Cede and recognize the custodial banks and brokers as record owners, so that ownership changes among Cede and the custodial banks and brokers would not constitute changes in record ownership for purposes of the Continuous Holder Requirement. It remains to be seen whether the Supreme Court will reject the suggested approach (as it has previously, albeit in a different context) and whether the Delaware Legislature may consider a legislative cure.

Background

After Dell announced a going private transaction, the plaintiff funds, engaging in so-called "appraisal arbitrage", bought Dell shares, rejected the merger consideration, and, after the merger, filed petitions for appraisal of their shares.

Continuous Holder Requirement. The Delaware appraisal statute requires that, for appraisal rights to be perfected, there cannot have been a change in the stockholder of record of the shares from the date of the appraisal petition through the effective date of the merger.

Federal "share immobilization" process. In the early 1970's, in response to a vast increase in the volume of stock trading, the federal government created a "share immobilization" program. Under this program, as it now exists:

- Record ownership by Cede. In lieu of retaining physical possession of shares of stock they beneficially own, stockholders often choose to entrust custody of the shares to custodial banks or brokers. The custodial banks and brokers deposit the shares with the federal depository, DTC. DTC's nominee, Cede, is the record holder on the books and records of the issuer. This system eliminates the need for issuers to change the name of the record holder on its books and records every time there is a transfer of beneficial ownership of shares.
- Transfer of shares from DTC to custodial bank. DTC holds shares "in fungible bulk" (i.e., without identifying specific shares with specific beneficial owners) until there is a reason to identify specific shares with specific beneficial owners. Such a reason arises when a stockholder petitions for appraisal of shares that it owns. Based on Delaware Supreme Court precedent, a corporation has the responsibility to "oversee" the surrender of shares after a merger. As a result, DTC has established procedures to remove the shares covered by an appraisal demand from the "fungible bulk" of shares it holds. DTC causes the issuer's transfer agent to issue paper stock certificates for the shares for which appraisal will be sought. The certificate is issued in Cede's name—so the same record holder continues to hold the shares for purposes of the Continuous Holder Requirement—and is delivered to the beneficial owner's custodial bank or broker.
- Custodial bank's back office procedures may result in a change of the record owner. DTC does not as a matter of course act as a custodian of paper stock certificates (even those issued in Cede's name). Thus, the custodial bank or broker typically elects either (a) to pay DTC for the separate service of holding the certificates in DTC's vault or (b) holds the certificates in the bank's or broker's own vault. If the certificates are placed in DTC's vault, there is no name change that occurs. However, some banks or brokers (for their own internal reasons) have policies prohibiting the holding

of certificates in their own vaults unless the certificates are in the name of the bank's or broker's nominee. Thus, a bank or broker with this policy will, as in the *Dell* case, change the name on the certificate from Cede to the bank's or broker's nominee—causing the change in record ownership that was held in *Dell* to have violated the Continuous Holder Rule.

Discussion

- **Court's interpretation of the Continuous Holder Requirement.** In *Dell*, it was undisputed that, from the date of the appraisal petition through the effective date of the merger:
 - The funds were continuously the beneficial owners of the shares;
 - Cede was the record holder of the shares on the company's books and records until, when the appraisal petition was filed, DTC transferred physical possession of certificates representing the shares to the funds' custodial banks, and the banks—as a result of their back office procedures requiring that they hold certificates only in their own nominee's name—changed the name on the certificates from Cede to the banks' nominees; and
 - The funds had not specifically approved, or even known about, the name changes, except insofar as the customer agreement with the custodial bank had provided for consent generally to the bank's procedures.

Nonetheless, the court held that the funds had not satisfied the Continuous Holder Requirement and therefore were not entitled to appraisal rights.

- **Probable appeal and consideration of Vice Chancellor Laster's suggested alternative approach; potential for legislative action.** We expect that the decision will be appealed to the Delaware Supreme Court. As noted, Vice Chancellor Laster, in his opinion, suggested that the Supreme Court adopt an alternative approach that, consistent with federal law, would recognize "DTC participants" (i.e., the custodial banks and brokers) as record holders for purposes of the Continuous Holder Requirement. Under that approach, the DTC participants' policies as to how to hold the paper certificates transferred from DTC would not affect a shareholder's right to appraisal. The Vice Chancellor noted that, in his 2010 *Kurz* decision, he had similarly advocated recognizing DTC participants as record owners (in that case, for purposes of analyzing whether the shares they held could be voted without a DTC omnibus proxy). In *Kurz*, the Supreme Court characterized the Vice Chancellor's discussion of the point as "obiter dictum" (i.e., without precedential effect) and stated that "a legislative cure [was] preferable" to the court's interpreting who is a "holder of record". It remains to be seen whether the Delaware Legislature may consider an amendment to the appraisal statute and whether, if *Dell* is appealed, the Supreme Court may reconsider the view expressed in *Kurz*.
- **Immediate impact.** The decision may immediately affect stockholders' access to appraisal rights. Companies involved in appraisal proceedings may challenge stockholders' rights to appraisal based on noncompliance with the Continuous Holder Requirement due to actions by stockholders' custodial banks or brokers. Pending further judicial or legislative developments, all parties involved in appraisal proceedings should evaluate how the decision affects their current or anticipated positions.

Practice Points

- Companies involved in appraisal proceedings should determine whether, under *Dell*, they can challenge any of the petitions based on violations of the Continuous Holder Requirement due to the back office procedures of the dissenting shareholders' custodial banks or brokers.
- Dissenting shareholders involved in appraisal proceedings should determine whether their petitions may be subject to challenge by the company under *Dell*.
- Beneficial owners of shares considering seeking appraisal should determine whether their custodial bank's or broker's policies upon receipt of certificated shares from DTC require a change of name in the record holder.
- Custodial banks should consider—on their own or in response to their customers' inquiries—revisions to their policies to the extent necessary to avoid their triggering a loss of appraisal rights for their customers. To avoid the need for a name change from Cede to a different record holder:
 - The bank (or the beneficial owner) could pay for the bank to utilize the DTC's vault for holding the stock certificates; or
 - The bank could not require that the certificates held in its own vault be in the name of the bank's own nominee.
- Custodial banks should also review their customer agreements to ensure that effective consent to their administrative procedures is provided.

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