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Corporate Governance Group Client Alert

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DELAWARE COURT CLARIFIES PROCESS FOR HOLDERS OF “STREET NAME” SHARES TO CAST VOTES AND SIGN CONSENTS

Treats DTC’s “Cede Breakdown” as Part of a Corporation’s Stock Ledger for Purposes of DGCL Section 219(c)

Over the years, the fact that most shares of U.S. public company stock are held in “street name” has generated a good deal of confusion in battles for corporate control. A product of our securities markets’ depository system in which the actual stock certificates are “immobilized” in a central depository to promote and facilitate securities trading, the holding of shares in street name in effect splits stock ownership between two groups – beneficial owners who possess the economic interest in the shares and record owners who, while lacking an economic stake, are registered as holders of record on the corporations’ stock ledgers and therefore possess the right to vote the shares under the Delaware General Corporation Law (“DGCL”). As the only remaining securities depository in the United States, the Depository Trust Company (“DTC”) plays a central role in this process by both clearing trades and serving as the record owner (under the name of its nominee, Cede & Co.) for nearly all street name shares beneficially owned by stockholders of U.S. public companies.

The Delaware Court of Chancery was recently asked to analyze the highly technical relationships between beneficial owners, banks and brokers and DTC in *Kurz v. Holbrook*.¹ In the context of a battle between rival stockholders for control of the board of directors of EMAK Worldwide, Inc., the Court held that banks and brokers may vote shares held on

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¹ C.A. No. 5019-VCL (Del. Ch. Feb. 9, 2010). An appeal from this decision was recently filed with the Delaware Supreme Court and, given the opinion’s departure from precedent, may be heard on an expedited basis.

behalf of their clients, the true beneficial owners, despite the lack of an omnibus proxy issued by DTC to the banks and brokers. Fundamental to this ruling was the Court's conclusion that DTC's "Cede breakdown," a company-specific listing of shares held by banks and brokers on behalf of their clients through DTC, should be considered part of a corporation's stock ledger for purposes of DGCL Section 219(c). As a consequence, banks and brokers who appear on the Cede breakdown now have the power to vote shares held in street name (in accordance with instructions received from their clients) as record holders, at stockholder meetings or for purposes of taking action by written consent, without first obtaining a DTC omnibus proxy.

Background

EMAK, a Delaware corporation based in Los Angeles, has two classes of stock: common stock and Series AA preferred stock. In late 2009, EMAK found itself the target of dueling consent solicitations seeking control of its board of directors. At the time, EMAK's board consisted of five sitting directors – two of whom were designated by Crown EMAK Partners, LLC through its ownership of the Series AA preferred stock and three of whom were elected by the holders of common stock – and two vacant seats.

One of the competing groups, Take Back EMAK, LLC ("TBE"), included Donald Kurz, a sitting director elected by the common stockholders. TBE proposed to take over a majority of the board by seeking a vote of the common stockholders to remove the other two EMAK directors previously elected by the common stockholders, without cause, and to fill the resulting vacancies with directors nominated by TBE. In response, the other group, led by Crown, proposed a series of bylaw amendments that would reduce the size of the board and thereby give it the ability, as the sole owner of the preferred stock, to elect the majority of directors in any given election. By December 21, 2009, TBE and Crown had delivered their respective consents and both groups claimed victory.

The manner in which TBE and Crown gathered their consents differed markedly. Because Crown's preferred stock gave it the right to designate two directors and approximately 28% of the total vote on all matters, other than election or removal of the directors to be elected by the common stockholders, Crown focused its solicitation on EMAK management and one large institutional holder. This simplified its interaction with DTC.

TBE, meanwhile, was forced to conduct a more typical solicitation of consents from a dispersed group of common stockholders with shares held in street name. Such a solicitation involves a series of proxies and authorizations. First, because DTC has been understood to have the power to vote shares of a corporation it holds on deposit because it is listed as the holder of record of those shares on the corporation's stock ledger, a DTC omnibus proxy is traditionally obtained. The DTC omnibus proxy has generally been thought to have the effect of transferring DTC's voting authority to the banks and brokers who originally deposited the shares with DTC on behalf of their clients. Next, the banks and brokers shift their newly-received voting authority to Broadridge Financial Services, Inc., a company that communicates with the beneficial owners of the shares via proxy materials and voting instruction forms. Finally, after receiving voting instructions from the beneficial owners, Broadridge votes the shares held at DTC in accordance with their wishes. It is important to note that unless Broadridge receives such instructions, in most cases neither DTC, Broadridge nor the banks and brokers have the authority under applicable NYSE and Nasdaq rules to vote the shares.

Not surprisingly, Crown and TBE challenged the other's consents, seeking relief under DGCL Section 225, which gives the Court of Chancery the power to resolve election disputes. TBE challenged the Crown consents on the basis that the bylaw amendments they sought to promote violated the DGCL.² With regard to the TBE consent solicitation, there was no dispute that Broadridge correctly collected, recorded and totaled the beneficial owners' voting instructions. Similarly, Broadridge received proper authorization from the banks and brokers to vote the EMAK shares on their behalf. Missing, however, was the DTC omnibus proxy transferring voting authority from DTC to the banks and brokers. With this link absent, Crown argued that legal authority to vote the EMAK shares never left DTC's control, rendering TBE's consents ineffective.³

The Court's Analysis

Before addressing the absence of a DTC omnibus proxy, the Court reiterated the "well-founded" Delaware policy that "only a stockholder of record can execute a written consent." DGCL Section 228(a), the provision governing actions by written consent, requires consents to be "signed by the holders of outstanding stock" who could "authorize or take such action at a meeting." In the Court's view, this effectively means that DGCL Section 228(a) "incorporates the concept of record ownership that governs voting at a meeting of stockholders." And because DGCL Section 219(c) and Delaware case law have consistently limited the right to vote to stockholders of record, the Court likewise determined that only record holders may execute a written consent. Without further analysis, this would have automatically voided the TBE consents because DTC, the presumptive record holder, did not execute them and no omnibus proxy was granted by DTC. In fact, Vice Chancellor Laster noted at the outset that "I will confess that when I first learned about the absence of a DTC omnibus proxy, I thought it was a clear winner" for Crown.

Delving deeper into the issue, however, the Court embarked on a comprehensive review of the depository system. This led the Court to the ultimate determination that DTC's Cede breakdown of a corporation's shares held on behalf of banks and brokers should be treated as part of the corporation's stock ledger for purposes of DGCL Section 219(c), thereby giving the banks and brokers listed on the breakdown the status of record holders entitled to vote the shares held (in DTC) on behalf of their clients.

In reaching this conclusion, the Court observed that the DTC omnibus proxy does not appear to be governed by "any federal statute or regulation, any listing standard, or any state statute or decision calling for [its issuance]." Rather, the Court noted that the DTC omnibus proxy "appears to have evolved spontaneously in the 1970s after Congress and the SEC implemented a policy of share immobilization to the depository system." Recognizing that "some mechanism would be needed for purposes of Delaware law to ensure that the depositories' voting authority was transferred to the brokers," the Court reasoned that the omnibus proxy was likely utilized as "the improvised coupling by which the federally mandated system of indirect ownership through DTC links up with Delaware's traditional system of direct ownership evidenced through the stock ledger." Though the Court recognized that this was a fine solution when the omnibus proxy is in fact obtained, it also observed that "when the system breaks down, as it did in this case, insisting on the need for the DTC omnibus proxy disenfranchises stockholders . . . contrary to Delaware public policy, which rests on a 'general policy against disenfranchisement.'"

² The Court sided with TBE on this issue and disallowed Crown's consent solicitation. For a discussion of this ruling, please see our Client Alert entitled "Delaware Court Rejects Bylaw Amendment Seeking to Unseat Directors by Reducing Size of Board" (March 19, 2010).

³ Crown also argued that TBE engaged in illegal vote buying, violated transfer restrictions on certain EMAK shares and entered into a transaction tainted by insider trading and false and misleading disclosures. The "vote buying" allegation will be discussed in a subsequent Client Alert.

Vice Chancellor Laster next examined other sections of the DGCL and the federal securities laws for guidance. For instance, the Court observed that the Cede breakdown had long been considered part of the materials that a stockholder is entitled to receive when demanding a stock list under DGCL Section 220(b), and pointed out that “Section 220 uses the same terminology as Section 219.” The Court also recognized that treating the Cede breakdown as a part of the stock ledger aligns Delaware law with federal depository system regulations “under which the participant banks and brokers, not DTC, are the record holders of the shares held by DTC.” For example, the Court noted that under the Securities Exchange Act of 1934, in order “to determine whether an issuer has 500 or more *record holders* of a class of its equity securities such that it must register [with the SEC] under 15 U.S.C. § 761(g), DTC does not count as a single holder of record,” [emphasis added] but rather, “[e]ach DTC participant member counts as a holder of record.”

The Court not only noted that treating DTC’s Cede breakdown as part of the stock ledger for purposes of DGCL Section 219(c) has the twin benefits of aligning Delaware law with federal law and protecting the stockholder franchise, but also could find no “practical or policy-based impediments to treating the Cede breakdown as part of the stock ledger.” According to the Court, Cede breakdowns are readily available to both corporations and their transfer agents if a company wants to learn exactly which banks and brokers own their street name shares. Furthermore, stockholders can obtain these materials by requesting a stock list under DGCL Section 220. Such access, in the Court’s opinion, “fully addresses any concerns about efficiency, certainty, and predictability of application.” The Court also narrowed the impact of its ruling by stipulating that its analysis “does not apply to any entity other than DTC in its role as a federally registered clearing agency,” and does not otherwise “alter the traditional distinction between record and beneficial ownership” for purposes of Delaware law.⁴

With the Cede breakdown considered part of EMAK’s stock ledger for purposes of DGCL Section 219(c), the Court was able to conclude that the banks and brokers who granted Broadridge authority to issue consents in support of TBE’s proposals were “stockholders of record entitled to express consent to corporate action without a meeting under Section 228(a).” Consequently, TBE’s consents were sufficient, without the need for a DTC omnibus proxy, to remove the targeted directors, elect TBE’s opposition slate and give TBE control of EMAK’s board of directors.

Conclusion

Kurz v. Holbrook offers much needed insight into the impact of street name shares on proxy/consent solicitations. As is often the case in Delaware corporate jurisprudence, “the policy of protecting against stockholder disenfranchisement” outweighed whatever countervailing considerations were brought before the Court.

It will be interesting to see whether the *Kurz* analysis will be applied to other DGCL provisions that rely on the concept of shares held of record to trigger rights or protections. For instance, DGCL Section 203, which imposes supermajority voting requirements on business combinations between a corporation and a stockholder who has acquired 15% or more of the corporation’s stock without prior board approval, applies only to corporations with a class of voting stock listed on a national securities exchange or “held of record” by more than 2,000 stockholders. Similarly, appraisal rights under DGCL Section 262 are not available with respect to shares of a target corporation engaging in a merger if the shares are (i) listed on a national securities exchange or “held of record” by more than 2,000 stockholders and (ii) being exchanged only for shares of another corporation listed on a national securities exchange or “held of record” by more than 2,000 stockholders. For his part, Vice Chancellor Laster does “not foresee any headaches” and notes that “the consequences of treating banks and brokers on the Cede breakdown as record owners [for purposes of these other sections] appear to range from neutral to beneficial.”

⁴ In this regard, the Court characterized “the relationship between DTC and its participant banks and brokers as fundamentally different from the relationships further up the chain.”

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