



## NEW DELAWARE STATUTE AIMS TO HELP CORPORATIONS CORRECT OLD MISTAKES

By Michael P. Weiner

Effective April 1, 2014, Delaware corporations will have statutory mechanisms as set forth in Sections 204 and 205 of the Delaware General Corporation Law (DGCL) to correct “defective corporate acts.” Section 204 sets out a process for the “[r]atification of defective corporate acts and stock” by a corporation’s directors and stockholders (actual and putative), while Section 205 permits a corporation, director, stockholder (actual or putative) or “any other person claiming to be substantially and adversely affected by a ratification pursuant to Section 204” to bring a petition before the Court of Chancery to validate any defective corporate act or putative stock, or to hear a challenge to the validity and effectiveness of a ratification undertaken under Section 204.

Although as a practical matter these mechanisms may be utilized primarily by early stage ventures, the reality is that Sections 204 and 205 provide a well-defined path to be followed by any Delaware corporation seeking to prepare itself to enter the private or public securities market or a liquidity event requiring stockholder participation and approval, without necessarily relying upon an omnibus “ratification of all prior acts” type resolution or consent and providing a defense against an extended line of Delaware cases that essentially hold that certain

“defective corporate acts” are void *ab initio* and consequently cannot be remedied.

Section 204 of the DGCL centers itself on a combination of board and stockholder actions to ratify the “defective act” or putative stock and requires certain disclosures to be made as part of the “cleansing” process. For purposes of Sections 204 and 205, “defective corporate act” is defined to include an “overissue” of shares; an unauthorized, and therefore void or voidable, election of directors; or any corporate act taken that was within the powers of the corporation at the time, but void or voidable due to a failure of authorization.

First, the board adopts a resolution identifying the defective act to be ratified; the time of the act; in the case of an issuance of shares of putative stock, the number and types of shares issued and the date(s) upon which the putative shares were purportedly issued; the nature of the defect in authorization of the act to be ratified; and that the board approves the ratification of the defective act.

The board then submits its resolution to the corporation’s stockholders for adoption (subject to certain exceptions). Notice must be given no less than 20 days in advance of the meeting date to each holder of valid and putative voting or nonvoting stock appearing on the records of the

corporation and also to those holders of valid and putative stock (whether voting or nonvoting) as of the time of the defective act (unless those holders cannot be identified from the records of the corporation). The notice to stockholders must include a copy of the board resolution and a statement that any claim that the ratification process was not done properly, or a claim that the Court of Chancery should, in its discretion, declare an attempted ratification to be ineffective or subject to certain conditions, must be brought within 120 days of the effective time of the underlying ratification action.

Assuming that the stockholders adopt the resolution, effective as of the validation time, the defective act shall no longer be deemed void or voidable as a result of the failure of authorization identified in the resolution and the effectiveness of the ratification shall be retroactive to the time of the defective act. In the case of a putative stock issuance, each share of putative stock shall be deemed to be an identical share of a share of outstanding stock as of the time it was purportedly issued.

Following the stockholders' adoption of the resolution, the corporation files a "certificate of validation" with the Delaware Secretary of State, and notice must be given to all holders of valid and putative stock, whether voting or not voting (whether of record or as of the time of the defective act), within 60 days following the date of adoption. The notice must include the same statement as to challenges that accompanied the original notice to stockholders.

Section 205 of the DGCL allows a corporation (or its successor entity), a member of the board of directors, a holder of valid or putative stock, or "any other person claiming to be substantially and adversely affected by a ratification pursuant to Section 204" to apply to the Court of Chancery to determine the validity and effectiveness of any

defective corporate act ratified pursuant to Section 204 (as well as the validity and effectiveness of the ratification process) as well as the validity and effectiveness of any defective corporate act not ratified. In addition, an application can be made to determine the validity of "any corporate act or transaction and any stock, rights or options to acquire stock."

It is important to note, however, that any action asserting that a ratification of a defective act is void or voidable because of the original defect in authorization, or that the court should, in its discretion, declare an attempted ratification to be ineffective or subject to certain conditions, must be brought within 120 days of the effective time of the underlying ratification action. This limitation shall not apply to an action that asserts that ratification was not accomplished in accordance with the requirements of Section 204, including a failure to give the appropriate notice.

Factors that may be considered by the Court of Chancery in evaluating any application submitted under Section 205 include:

- whether the defective corporate act was originally taken with the belief that it was procedurally correct;
- whether the corporation has treated the defective corporate act as valid and any person has acted in reliance upon the perceived validity of the defective corporate act; and
- whether any person will be harmed by the ratification of, or failure to ratify, the defective corporate act.

Following its consideration of the application, the Court of Chancery may take a variety of actions. The court may declare that a ratification is invalid or impose certain conditions on its validity to avoid harm to any person materially adversely affected by a ratification; declare that

shares of putative stock are shares of valid stock; order that a meeting of holders of valid or putative stock be held; or make other orders as the court may deem proper under the circumstances.

At the risk of stating the obvious, corporations and their counsel should strive to comply fully with all applicable statutory and organizational documentation requirements as to the authorization and implementation of all corporate acts. However, at least as to corporations organized under the laws of Delaware, in the unhappy event that errors are discovered (which we know with certainty will

typically happen at the most inopportune time), there is now a clear roadmap to addressing the problem with full transparency to all interested parties that, if followed, will provide the corporation with the assurance that it can proceed with its intended plans for growth, combination, etc., having eliminated these issues in accordance with applicable law.

For more information about this alert or if you have any questions or concerns, please contact Michael P. Weiner at 609.844.3032 or [mweiner@foxrothschild.com](mailto:mweiner@foxrothschild.com) or any member of Fox Rothschild's Corporate Department.



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