

Validating the Voidable—A Guide to the New Procedures to Ratify Defective Corporate Acts Under Delaware Law

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On June 30, 2013, the governor of the State of Delaware signed legislation that amends the Delaware General Corporation Law (“DGCL”).¹ Among the amendments are two new sections of the DGCL, Section 204 and Section 205, which relate to so-called “defective corporate acts.”² A defective corporate act is any act or transaction that would have been within the power of the corporation at the time taken but which is “void or voidable” due to a failure of authorization.³ A defective corporate act also includes any overissue of corporate stock in excess of amounts properly authorized for issuance (known as “putative stock”) or the election or appointment of directors or other action within the corporation’s powers that was not properly authorized in accordance with the DGCL or the corporation’s organizational documents.⁴

New Section 204 of the DGCL establishes a process by which a Delaware corporation can ratify defective corporate acts. New Section 205 of the DGCL grants the Delaware Court of Chancery jurisdiction to, among other things, determine the validity and effectiveness of any defective corporate act (whether or not ratified pursuant to new Section 204) and to determine the validity and effectiveness of any ratification pursuant to new Section 204. No defective corporate act will be deemed void or voidable solely as a result of a failure of authorization if ratified in accordance with Section 204 or validated by the Court of Chancery under Section 205. New Section 204 and new Section 205 of the DGCL become effective on April 1, 2014.⁵

¹ H.B. 127, 147th Gen. Assemb., Reg. Sess. (Del. 2013), available at <http://www.legis.delaware.gov/LIS/LIS147.nsf/vwLegislation/5A64A8392AC7904285257B5F0056EEF6?open>.

² DEL. CODE ANN. tit. 8, §§ 204–205 (2013) (effective Apr. 1, 2014), available at <http://delcode.delaware.gov/title8/c001/sc06/index.shtml>.

³ § 204(a).

⁴ § 204(h).

⁵ § 204.

Impact of Defective Corporate Acts

The impact of a defective corporate act can be materially adverse to a corporation. For example, if the board of directors of a corporation is elected by the holders of putative stock (as opposed to valid stock) of the corporation, this can invalidate the election. If the board is not properly elected, actions taken by, at the direction of, or with the approval of the board may be void or voidable. The directors themselves may be deemed to be operating outside the scope of their proper authority as directors and/or may lose the benefit of certain protections and privileges under the corporation's organizational documents and applicable law. This or other defective corporate acts may result in the corporation being in breach of standard contractual representations and warranties, including those relating to compliance with organizational documents and applicable law and the proper election of directors or issuance of stock, which could result in liabilities and losses to the corporation.

The potential consequences of a defective corporate act can be especially significant to a corporation that wants to raise capital, whether in the public or private markets, or that desires to combine or partner with a third party or to acquire or be acquired by another business. Extensive due diligence review is generally a condition to any material investment, partnership, acquisition, or similar transaction. Such review usually encompasses the corporate books and records of the target/parties, and counsel will typically review all actions of the target's/parties' stockholders and boards of directors to ensure compliance with applicable law and the target's/parties' organizational documents. Any defective corporate act that is void or that may be voidable as to any party, but particularly the investment or transaction "target," creates risk to the other party(ies) to the transaction. If these risks cannot be eliminated or minimized to the satisfaction of the other party(ies), the transaction may be abandoned.

Significance of New Ratification Procedures

New Section 204 and new Section 205 of the DGCL do not represent the exclusive means of ratifying and validating defective corporate acts in Delaware, and other means of ratification and validation remain in effect.⁶ Nevertheless, the addition of these new sections to the DGCL is significant for a variety of reasons. First, this development clarifies the state of the law in Delaware with respect to the ability to ratify or validate defective corporate acts. A line of cases in Delaware previously held that certain defective corporate acts (including overissues of stock) were deemed void, meaning they could not be ratified or validated.⁷ This also meant that, even if the underlying

⁶ Defective corporate acts are capable of ratification by means outside those prescribed by Section 204. Methods for doing so include board ratification and shareholder ratification (i.e., a fully informed vote by the board and/or stockholders, as applicable, approving an action that does not legally require board and/or stockholder approval as a prerequisite to effectiveness).

⁷ See, e.g., *STAAR Surgical Co. v. Waggoner*, 588 A.2d 1130, 1136 (Del. 1991) (finding that "[s]tock issued without authority of law is void and a nullity."); *Blades v. Wisheart*, 2010 WL 4638603 (Del. Ch. Nov. 17, 2010) (holding that because a stock split failed to adhere to the required corporate formalities,

defect was unintentional, or inadvertent, the consequences of such a defect—which as noted above, can be significant—would be irrevocable. The intent and effect of these recent changes to the DGCL is to effectively reverse this line of cases by establishing a clear process by which any defective corporate act may be ratified or validated and thereby no longer deemed void or voidable.⁸

Second, Delaware is relatively unique among states in having adopted a statutory process for the ratification and validation of defective corporate acts, which may solidify Delaware’s standing as a favored location for business incorporation. Among the other states, only Pennsylvania has established a statutory process pursuant to which defective corporate acts may be ratified, although its process is targeted to a specified type of deficiency.⁹ Delaware has long been regarded as, and prides itself on, having a flexible yet sophisticated statutory schema and body of laws relating to corporate organization and governance matters. New Section 204 and new Section 205 of the DGCL appear well in keeping with the spirit of the rest of the DGCL and the state’s overall approach to governance matters, the effect of which has established a favorable climate for business formation and business transaction and investment activity.

Ratification of a Defective Corporate Act Under Section 204

The following summarizes the key elements of the process set forth in new Section 204 for a corporation to ratify a defective corporate act:¹⁰

1. The board of directors must adopt a resolution ratifying the defective corporate act, which resolution must include certain elements specified in Section 204.¹¹
2. If the defective corporate act in question would have required stockholder approval at the time originally taken, the board of directors must submit the

both the stock split and certain subsequent stock transfers purportedly effected by the company were invalid and void).

⁸ H.B. 127, 147th Gen. Assemb., Reg. Sess. (Del. 2013):

Section 204 is intended to overturn the holdings in case law . . . that corporate acts or transactions and stock found to be “void” due to a failure to comply with the applicable provisions of the General Corporation Law or the corporation’s organizational documents may not be ratified or otherwise validated on equitable grounds.

⁹ The Pennsylvania statute specifically addresses corporate acts rendered defective based on a corporation’s failure to properly file and/or record document(s) evidencing the corporate action with the recorder of deeds. See PA. CONS. STAT. § 505 (2007), available at <http://www.legis.state.pa.us/WU01/LI/LI/CT/HTM/15/00.005.005.000..HTM>.

¹⁰ New Section 205 confers jurisdiction on the Court of Chancery to determine the validity of a ratification using either a traditional method or the new Section 204. New Section 205 does not prescribe any standard of review for the Court of Chancery to employ in deciding such matters, and any judgment of the court is likely to depend significantly on the facts and circumstances presented. For these reasons, this Client Alert does not address the specific process to seek validation by the Court of Chancery of any defective corporate act.

¹¹ *Supra* note 2, at § 204(b).

ratifying resolution to a vote of all then-current holders of valid stock and putative stock, as well as all holders of valid stock and putative stock at the time of the defective corporate act unless their identities or addresses cannot be determined from the corporation's records.¹²

3. If the defective corporate act in question would have required a filing with the Delaware Secretary of State (e.g., a certificate of amendment, certificate of designation, certificate of merger, or other instrument), then the corporation must file a certificate of validation with the Delaware Secretary of State pursuant to Section 103 of the DGCL.¹³
4. If the corporation is not required to submit the ratifying resolution to a vote of its stockholders as described in #2 above, then the corporation must send prompt notice of the adoption of the ratifying resolution to all then-current holders of valid stock and putative stock, as well as all holders of valid stock and putative stock at the time of the defective corporate act unless their identities or addresses cannot be determined from the corporation's records.¹⁴
5. Any notice submitted to the corporation's stockholders as described in #2 or #4 above must include a statement that any claim that the defective corporate act is void or voidable due to the identified failure of authorization (or that the Court of Chancery should so declare or find that the proposed ratification pursuant to Section 204 is not effective) must be brought within 120 days from the "validation effective time."¹⁵
6. The "validation effective time" is the later of: (a) if the corporation is required to submit the ratifying resolution to a vote of the stockholders as described in #2 above, the time at which the resolution is approved by the stockholders, or if the corporation is not required to submit the ratifying resolution to a vote of the stockholders as described in #2 above, then the time at which notice is given to the stockholders as described in #4 above, and (b) the time at which any certificate of validation filed as described in #3 above becomes effective in accordance with Section 103 of the DGCL.¹⁶

Under the DGCL, only a validly elected board is empowered to exercise self-help measures. Therefore, if the board of directors of the corporation is not validly elected (i.e., if the defective corporate act in question relates to a failure of authorization in respect of the election of board members), the corporation would need to seek relief

¹² § 204(d).

¹³ § 204(e).

¹⁴ § 204(g).

¹⁵ § 204(g).

¹⁶ § 204(h)(6).

from the Court of Chancery under new Section 205 or existing Section 225¹⁷ of the DGCL.

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¹⁷ Section 225 of the DGCL provides a judicial process through which a corporation's shareholders, officers, or directors may challenge the appointment, removal, or resignation of any director or officer of a corporation.