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Seth Barrett Tillman



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Restoring Equity: Delaware's Legislative Cure for Defects in Stock Issuances and Other Corporate Acts

By C. Stephen Bigler and John Mark Zeberkiewicz*

In 2008, this journal published an article noting the difficulty under Delaware law in determining whether defects in stock issuances would render the stock void, and thus incapable of being validated or ratified, or merely voidable, and thus susceptible to cure by ratification. The Delaware legislature has adopted amendments to the General Corporation Law of the State of Delaware, which amendments will become effective on April 1, 2014, that are designed to overrule the existing precedents requiring that defective stock and acts be found void. The amendments expressly provide that defects in stock issuances and other acts render such stock and acts voidable and not void, if ratified or validated in accordance with the new ratification statutes. The amendments provide Delaware corporations with two alternative paths—one involving remedial action taken at the corporation's initiative, the other involving a court proceeding—to ratify or validate stock and other corporate acts that, due to a defect in authorization, might under prior law have been void and incapable of ratification. In this article, we summarize the reasons why the ratification statutes were necessary, provide an overview of the new Delaware ratification statutes, and discuss examples of circumstances where the ratification statutes could be utilized, specific types of defects that could be validated, which alternative path (self-help or court-assisted) might be appropriate in various circumstances, and the effect of validation.

In 2008, this journal published an article noting the difficulty under Delaware law in determining whether defects in stock issuances would render the stock void, and thus incapable of being validated or ratified, or merely voidable, and thus susceptible to cure by ratification.¹ The article proposed that the Delaware courts apply the policy underlying Article 8 of the Delaware Uniform Commercial Code (the "Delaware UCC") to permit overissued stock to be cured by a subsequent amendment to the issuer's certificate of incorporation, and stock held by innocent purchasers for value to be treated as valid regardless of whether the

* C. Stephen Bigler and John Mark Zeberkiewicz are directors of Richards, Layton & Finger, P.A., Wilmington, Delaware. Attorneys at Richards, Layton & Finger, including the authors, were involved in drafting the legislation discussed herein. The opinions expressed in this article are those of the authors and not necessarily those of Richards, Layton & Finger or its clients.

1. C. Stephen Bigler & Seth Barrett Tillman, *Void or Voidable?—Curing Defects in Stock Issuances Under Delaware Law*, 63 BUS. LAW. 1109 (2008) [hereinafter *Void or Voidable*].

stock had been defectively issued.² The Delaware Court of Chancery, however, did not adopt that approach,³ and in the ensuing years issued several opinions finding or indicating that existing Delaware Supreme Court precedent required it to find stock that was defectively issued void, despite the difficult consequences to all concerned.⁴

To address this issue, the Delaware legislature has adopted amendments to the General Corporation Law of the State of Delaware ("DGCL"), effective on April 1, 2014, that are designed to overrule the existing precedents requiring that defective stock and acts be found void.⁵ The amendments expressly provide that defects in stock issuances and other acts render such stock and acts voidable and not void, and provide Delaware corporations with two alternative paths to validate stock and other corporate acts that, due to a defect in authorization, might under prior law have been void and incapable of ratification.⁶

In this article, we summarize the reasons why the ratification statutes were necessary, primarily to provide a framework to explain the types of defects those statutes are intended to address. We then provide an overview of the new Delaware ratification statutes. Finally, we conclude by describing the manner in which the ratification statutes are intended to operate, give examples of circumstances where the ratification statutes could be utilized and specific types of defects that could be validated, which alternative path (self-help or court-assisted) might be appropriate in various circumstances, and the effect of validation.

I. WHY ARE THE RATIFICATION STATUTES NECESSARY?

Before summarizing the ratification statutes, it is important to review the reasons underlying their adoption. As noted in *Void or Voidable*:

In a number of leading cases, the Delaware Supreme Court has treated the statutory formalities for the issuance of stock as substantive prerequisites to the validity of the

2. *Id.* at 1148–51 ("In conclusion, we suggest that the policy underlying the [Delaware Uniform Commercial Code] to validate stock, notwithstanding technical defects in its issuance, in the hands of innocent purchasers for value should be recognized as a principle of law, not solely as a principle of equity, and should be applied by the Delaware courts as such.").

3. See Transcript of the Chancellor's Ruling on Plaintiffs' Motion for Default Judgment and Intervenor's Motion for Attorneys' Fees and Costs at 12–13, *Noe v. Kropf*, C.A. No. 4050-CC (Del. Ch. Jan. 15, 2009).

4. See, e.g., *Olson v. ev3, Inc.*, C.A. No. 5583-VCL, 2011 WL 704409, at *7 (Del. Ch. Feb. 21, 2011); *Blades v. Wisheart*, C.A. No. 5317-VCS, 2010 WL 4638603, at *12 (Del. Ch. Nov. 17, 2010).

5. 79 Del. Laws ch. 72 (2013) (enacting new sections 204 and 205 of the DGCL, which are referred to herein as the "ratification statutes"). Although amendments to the DGCL typically become effective on August 1 of the year in which they are enacted, the effectiveness of the ratification statutes was delayed until April 1, 2014 to give the Delaware Secretary of State additional time to update its processing systems to accommodate the "certificate of validation" that, in certain cases, must be filed in connection with a ratification under new section 204 of the DGCL. See William J. Haubert, John Mark Zeberkiewicz & Brigitte V. Fresco, *Significant Proposed Amendments to the General Corporation Law of the State of Delaware* INSIGHTS, June 2013, at 27. Because the ratification statutes are principally intended to address defects in stock and stock issuances, they do not apply to nonstock corporations. See DEL. CODE ANN. tit. 8, § 114(b)(2) (West, Westlaw through 79 Laws 2013, chs. 1–185).

6. DEL. CODE ANN. tit. 8, §§ 204, 205 (West, Westlaw through 79 Laws 2013, chs. 1–185).

stock being issued, and the court has determined that failure to comply with such formalities renders the stock in question void. A finding that stock is void means that defects in it cannot be cured, whether by ratification or otherwise. Thus, practitioners finding defects in stock issuances are put in the uncomfortable position of having to make a judgment whether the defect is one that renders the stock void, in which case ratification is not an option, or voidable, in which case ratification is an option.⁷

Since that time, the Delaware courts have continued to apply the legal analysis articulated by the Delaware Supreme Court in *STAAR Surgical Co. v. Waggoner*⁸ in analyzing the validity of stock, and have issued several additional opinions finding corporate stock to be void, based in part on the principle that equity is powerless in the face of defective stock issuances.⁹ The Delaware Court of Chancery relied on this principle in *Blades v. Wisheart*.¹⁰ As with many of the cases addressing the validity of stock issuances, the court's holding in *Blades* was issued in the context of a so-called section 225 action¹¹—in this case, a control dispute over Global Launch, Inc., an upstart “internet layaway” company.¹² Global Launch had been organized by, and owed its capital structure largely to, an attorney who was apparently unfamiliar with certain technical procedures under the DGCL.¹³ The opinion catalogues many of the non-compliant acts, but the principal defect giving rise to the court's key holding arose from Global Launch's ill-fated attempt to effect a five-for-one forward stock split, the apparent purpose of which was to increase the number of shares available for sale to investors and for distribution to employees as compensation.¹⁴ Global Launch's board of directors approved an amendment to the certificate of incorporation in

7. *Void or Voidable*, *supra* note 1, at 1110 (footnotes omitted).

8. 588 A.2d 1130, 1137 (Del. 1991). The Delaware Supreme Court in *STAAR* held that because the “issuance of corporate stock is an act of fundamental legal significance having a direct bearing upon questions of corporate governance, control and the capital structure of the enterprise,” strict compliance with technical procedures must be observed. *Id.* at 1136.

9. See *Blades*, 2010 WL 4638603, at *12 (“But what is more critical is that *STAAR* and other binding precedent make clear that I cannot ignore the statutory infirmity of the stock split because my equitable heartstrings have been plucked. That is, in the sensitive and important area of the capital structure of the firm, law trumps equity.” (footnote omitted)); see also *In re Native Am. Energy Grp., Inc.*, C.A. No. 6358-VCL, 2011 WL 1900142, at *6 (Del. Ch. May 19, 2011) (“The Delaware Supreme Court refused to ‘trivialize’ compliance with the statutory requirements by invoking equitable considerations and ‘emphasize[d] that our courts must act with caution and restraint when granting equitable relief in derogation of established principles of corporate law.’” (citations omitted)). Of course, equity may trump law in the case where stock is validly issued under the DGCL to insiders or through some other breach of fiduciary duty. See *Johnston v. Pedersen*, 28 A.3d 1079, 1092 (Del. Ch. 2011) (“Because the defendants adopted the class vote provision in breach of their duty of loyalty, the holders of the Series B Preferred are not entitled to a class vote in connection with the removal of the incumbent board and the election of a new slate by written consent.”).

10. *Blades*, 2010 WL 4638603, at *10–12.

11. See, e.g., *id.*; *Reddy v. MBKS Co.*, 945 A.2d 1080 (Del. 2008); *Noe v. Kropf*, C.A. No. 4050-CC, 2008 WL 4603577 (Del. Ch. Oct. 15, 2008); *Superwire.com, Inc. v. Hampton*, 805 A.2d 904 (Del. Ch. 2002); *Kalageorgi v. Victor Kamkin, Inc.*, 750 A.2d 531 (Del. Ch. 1999), *aff'd*, 748 A.2d 913 (Del. 2000) (TABLE).

12. *Blades*, 2010 WL 4638603, at *2.

13. *Id.*

14. *Id.* at *3.

Global Launch share certificates Wetzel sent them, some of whom Blades reached out to in preparation for his ineffective stockholders meeting in November, 2009.

A similar situation was encountered in the *Liebermann* case, where the defendant directors had participated in the creation and sale of preferred stock to outside investors that was never properly authorized in the corporation's certificate of incorporation, but defended their use of a written consent to remove incumbent board members on the ground that the consents represented a majority of the *validly issued* common stock. This court, in upholding the written consent and the defendants' argument with respect to the invalidly issued preferred stock, noted the Pyrrhic nature of the victory:

Although it might be galling to the plaintiffs to have Frangiosa and D'Ambrosio take advantage of a legal problem they contributed to creating, the inequity that results is no greater than that which occurred in *STAAR*, wherein a purchaser who had accepted substantial economic risk in exchange for shares was denied the benefits of the bargain he thought he made by the company with whom he had made it. . . . Even more critical, my recognition of the New Board as the proper board of MobileToys does not leave the investors [holding the invalid preferred stock] without a remedy. . . . Frangiosa and D'Ambrosio will now bear primary responsibility for directing MobileToys' response to this substantial legal problem, which exposes the company (and perhaps its directors) to rather obvious claims (e.g., for equitable rescission or unjust enrichment). Another court on another day may well confront disputes arising out of the New Board's decisions, if it is unable to address the purchasers' concerns in a manner that generates consensus.

Global Launch and its newly elected directors will face the same difficult situation. They will have to address various claims by investors, employees, the defendants, and others if they do not straighten out the situation fairly.⁴⁵

Given that the Court of Chancery, due to *STAAR* and other binding precedent, has found it is incapable of curing stock and other acts suffering from defects in authorization notwithstanding the equitable consequences, corporations and their counsel, when faced with questions over validity, often have few practical options. As noted in *Void or Voidable*, the Delaware UCC takes the approach that treating the stock as valid in the hands of a purchaser for value is often the best remedy, since it places parties in the position they believed they occupied.⁴⁶ Any other remedy, particularly for a public company, could effectively plunge the company into chaos.⁴⁷ Unfortunately, the Court of Chancery found it was re-

45. *Blades v. Wisheart*, C.A. No. 5317-VCS, 2010 WL 4638603, at *12-13 (Del. Ch. Nov. 17, 2010) (alterations in original) (footnotes omitted).

46. *Void or Voidable*, *supra* note 1, at 1144-48.

47. Based on its public filings, Vitacost.com, Inc., upon discovering potential defects in its capital structure due to non-compliance with Delaware corporate law, was evidently forced to consider drastic measures to remedy the defects, including a possible reorganization under chapter 11 of the U.S. Bankruptcy Code. On November 15, 2010, Vitacost issued a press release announcing that its audit committee, with the assistance of outside advisors and consultants, was undertaking an internal review of certain of the valuation methods used in stock-based compensation grants and awards and other matters. See Vitacost.com, Inc., Current Report (Form 8-K), at 1 (Nov. 15, 2010). Less than a month later, Vitacost announced that its audit committee, together with its advisors, had uncovered "potential defects in the Company's corporate organizational and formation documents and certain