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Extract from John Mark Zeberkiewicz & Tiffany N. Piland, Valid Issuance of Capital Stock, Review of Securities & Commodities Regulation (2011) (practitioner-edited), citing Bigler & Tillman's Void or Voidable? -- Curing Defects in Stock Issuances Under Delaware Law

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VALID ISSUANCE OF CAPITAL STOCK

In two recent cases, the Delaware Court of Chancery has affirmed the importance of proper action by directors in setting the terms upon which capital stock may be issued. Corporate formalities must be carefully followed, and while directors have broad authority to set the consideration for the issuance of capital stock, they may not delegate that authority to corporate officers.

By John Mark Zeberkiewicz and Tiffany N. Piland *

In recent months, the Delaware Court of Chancery has issued two opinions, *Olson v. ev3, Inc.*¹ and *Blades v. Wisehart*,² dealing with the validity of capital stock. While each arose in a unique factual setting, the principles the court articulated may be relevant to corporations considering stock issuances, particularly those outside of the traditional underwritten offering context, such as at-the-market offerings and other equity programs. Since these programs typically contemplate a series of individual decisions, made over a fixed horizon, regarding the issuance of a number of shares at prices based on prevailing market rates, in each case within pre-established parameters, it would be nearly impossible to run such programs effectively if the full board of directors were required to meet to authorize

each issuance.³ For that reason, boards of directors, when establishing such programs, frequently delegate the authority necessary to implement the programs.

But unless it is structured properly, the board's delegation of the authority to issue capital stock may conflict with Delaware law – which in turn may result in questions over the validity of the stock issued pursuant

¹ 2011 WL 704409 (Del. Ch. Feb. 21, 2011).

² 2010 WL 4638603 (Del. Ch. Nov. 17, 2010).

³ At-the-market offerings, for example, “enable issuers to offer and sell their equity securities through one or more registered broker-dealers in a series of public, registered transactions effected over an extended period of time and at then-prevailing market prices. . . . The issuer enters into a sales agency agreement with a broker-dealer, pursuant to which the firm agrees to sell shares on behalf of the issuer from time to time, as instructed, subject to a specified maximum number of shares and/or maximum offering price.” Barbara J. Endres & Kersti Hanson, *At-the-Market Offerings – Implications of Regulation M*, 43 Rev. Sec. & Comm. Reg. 1 (2010).

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IN THIS ISSUE

• VALID ISSUANCE OF CAPITAL STOCK

a dispute over control of Global Launch, Incorporated, an “internet layaway” corporation conceived and largely founded by Rusty Blades. Global’s two initial stockholders were Rusty Blades and an Ohio corporation named The Ohio Company.

Global was in need of capital in its initial year, and its principals wanted to use shares to motivate and reward employees. Global’s board accordingly attempted to effect a 5-for-1 forward stock split to increase the number of shares that could be offered for sale or as compensation. In this connection, Global’s board adopted an amendment to the certificate of incorporation. But the certificate of amendment was not filed until months after the resolution approving the amendment was adopted. In any event, the late-filed certificate of amendment referenced only the increase in the authorized shares of capital stock – it contained no language effecting the split. Nonetheless, the parties proceeded as if the split had occurred.

In the ensuing months, Rusty Blades was forced out of the company after pleading guilty to a misdemeanor that it was believed would bring disrepute upon Global. While in exile from Global, Blades’s former co-director (and Global’s then-counsel) began transferring shares of stock held by Blades and The Ohio Company – which shares were believed by all parties to have been created in the forward stock split. In an attempt to regain control of the board, Blades called a meeting of stockholders to remove the directors and elect a new board, but in recognition that the meeting likely was not validly called, and with an increasing awareness of the problems with the subsequent stock transfers, Blades and The Ohio Company adopted a written consent removing all of the directors and naming a new board.

In the court’s review of which directors were in fact validly in office, the relevant question was whether Blades and The Ohio Company were the only holders of valid shares of Global at the time the unanimous written consent was executed. The court agreed with Blades’s position that the only shares that had been validly issued were those initially issued to Blades and The Ohio Company. The court summarized the steps required to effect a valid forward stock split by charter amendment: the board of directors must approve and declare advisable the amendment to the certificate of incorporation; the stockholders must adopt the amendment; and the amendment must be executed and filed with the Delaware Secretary of State. In this case, because the language effecting the stock split was not included in the certificate of amendment, the court declared that the shares that otherwise would have resulted from the split were invalid.

As with *ev3*, the court’s ruling in *Blades* highlights the importance of complying with statutory formalities when changing the capital structure of a corporation – that is, defects in the authorization of stock may result in a finding that putative shares are in fact void. “The stock purportedly held by minority stockholders, having never been properly authorized through a valid stock split, is, to borrow a phrase from *STAAR*, ‘void and a nullity.’”²⁹ Moreover, equitable considerations may not be used to validate otherwise defectively issued stock.³⁰ As articulated by the Delaware Supreme Court in *STAAR*, 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,” the law requires compliance with the statutory formalities.³¹

PRACTICAL IMPLICATIONS

As discussed above, the board of directors of a Delaware corporation, as a statutory matter, has virtually exclusive control over changes to the corporation’s capital structure. The statutory regime reflects the public policy consideration that claims upon a corporation’s equity are so important, and so fundamental to the corporation, that the issuance of shares representing those claims must be effected and documented with a high degree of formality.³² Thus,

²⁹ *Blades*, 2010 WL 4638603, at *12 (citing *STAAR Surgical Co. v. Waggoner*, 588 A.2d 1130, 1136 (Del. 1991)).

³⁰ *Id.* (“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.”); see also *In re Native American Energy Group, Inc.*, 2011 WL 1900142, at *6 (Del. Ch. May 19, 2011) (dismissing petitioner’s request for the court to determine, in the absence of an actual controversy, whether non-unanimous stockholder ratification would be effective to validate invalidly issued shares and noting that in *STAAR*, “[t]he 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). For an expanded discussion of the effect of defects in stock issuances, see C. Stephen Bigler & Seth Barrett Tillman, *Void or Voidable? – Curing Defects in Stock Issuances Under Delaware Law*, 63 Bus. Law. 1109 (2008).

³¹ 588 A.2d at 1136.

³² See also *Kalageorgi v. Victor Kamkin, Inc.*, 750 A.2d 531, 537-38 (Del. Ch. 1999) (“[O]ur statutory scheme envisions a model