The M&A LAWYER

July/August 2013 ■ Volume 17 ■ Issue 7

Legislative Solutions to Practitioner Problems: Important Amendments to the Delaware General Corporation Law

BY EDWARD P. WELCH, ALLISON L. LAND, CLIFF C. GARDNER AND CHRISTOPHER M. DIVIRGILIO

Edward P. Welch and Allison L. Land are partners, and Cliff C. Gardner and Christopher M. DiVirgilio are associates, in the Wilmington, Delaware office of Skadden, Arps, Slate, Meagher & Flom LLP. Contact: edward.welch@skadden.com, allison.land@skadden.com, cliff.gardner@skadden.com or christopher.divirgilio@skadden.com.

On June 30, 2013, Delaware Governor Jack Markell signed into law legislation amending the Delaware General Corporation Law (the "DGCL") in a number of important ways. These amendments are expected to have a significant impact on the structure of mergers and acquisitions, and corporate practice, in Delaware. First, the DGCL has been amended to add § 251(h), which will allow consummation of second-step mergers without stockholder approval following a tender or exchange offer in certain circumstances.[1] Second, the DGCL has been amended to add §§ 204 and 205, which will define corporate and judicial procedures for ratifying defective corporate acts.[2] The legislation also includes various other amendments to the DGCL, including the use of formulas for stock issuance pricing and restrictions on "shelf" corporations, which are beyond the scope of this article.[3]

Section 251(h): Short-Form Mergers In Two-Step Transactions

Acquisitions often employ a two-step structure in which the acquiror first launches a tender or exchange offer for any and all outstanding shares. Upon the

CONTINUED ON PAGE 4

Content HIGHLIGHTS

WEST®

41315218

CONTINUED FROM PAGE 1

close of the tender or exchange offer, the acquiror then acquires any shares not tendered in the offer by way of a second-step merger to complete the acquisition.

Issue Addressed by the Proposed Statute

Under Delaware law, a "short-form" merger pursuant to DGCL § 253 does not require stockholder approval of the second-step merger, but can be used only if the acquiror owns at least 90% of the outstanding shares of each class of the target's voting stock after the first-step tender or exchange offer. If the tender or exchange offer results in the acquiror owning less than 90% of the outstanding shares of each class of the target's voting stock, a "long-form" merger must be utilized, requiring the mailing of a proxy statement to target stockholders and holding a stockholder meeting to approve the merger. However, whether a short-form or long-form merger is utilized, the second-step merger is a *fait accompli* if the acquiror owns enough shares after the tender or exchange offer to approve the merger as a long-form merger, which typically is a precondition to the closing of the first-step tender or exchange offer. In such a case, the question becomes whether the second-step merger can be accomplished quickly (through use of a short-form merger) or whether stockholders must wait to receive their merger consideration until the stockholder meeting necessary to approve a long-form merger is held. Due to the expense and delay associated with preparing, filing and mailing a proxy statement and holding a stockholders meeting, a second-step, long-form merger often is an expensive formality for a corporation that is, after a successful first-step tender or exchange offer, controlled by a stockholder holding sufficient shares to approve a long-form merger. Section 251(h) remedies this situation.

Existing Solutions

Although regulatory and market-based remedies to this situation have been developed over time, the existing solutions have not proven to be effective to eliminate uncertainty as to whether a short-form merger may be utilized. For example, subsequent offering periods permitted under Exchange Act Rule 14d-11 provide the acquiror with additional opportunities to acquire sufficient shares in the tender or exchange offer to permit the short-form merger, but do not guarantee that the acquiror will reach the required 90% threshold.

Including a "top-up option" in the merger agreement is a second solution. Typically, these provisions entitle an acquiror to purchase authorized and unissued shares of the target's stock and/or its treasury shares and are usually exercisable only if a specified "minimum threshold" percentage of the target's outstanding shares tender into the offer. These provisions have become common in two-step merger agreements.[4] The ability to successfully utilize a top-up option, however, depends upon the number of authorized but unissued shares and/or treasury shares the target has available.[5] As a rule of thumb, for every 1% that an acquiror's ownership falls short of the 90% short-form threshold for a particular class, a number of target shares equal to 10% of the outstanding stock of such a class prior to the offer must be issued to the acquiror under the top-up option in order to reach the 90% threshold.[6] The target's authorized capitalization may be insufficient to permit it to grant a top-up option, making it an imperfect solution that cannot be utilized in all transactions.

A third solution that has been used in a number of transactions is a dual-track structure, in which the first-step tender or exchange offer and preparation of the proxy statement for the second-step, long-form merger are commenced concurrently.[7] While this solution may save time[8] compared to running consecutive processes for the first-step offer and second-step merger, it avoids little, if any, of the expense of the long-form merger process and does not eliminate the uncertainty as to whether the stockholder meeting to approve the merger will be held contemporaneously with the closing of the tender or exchange offer. Indeed, if the acquiror does reach 90% via the tender or exchange offer, or by way of subsequent offering periods or a top-up option, a dual-track structure results in unnecessary expenses, as the proxy statement prepared and filed with the SEC would be rendered moot.

Section 251(h): The New Solution

Section 251(h) permits merger agreements entered into after August 1, 2013 to contain a provision eliminating the need for a stockholder vote for a second-step merger following consummation of a tender or exchange offer if certain conditions are met.[9] Section 251(h) thus eliminates the need for subsequent offering periods, top-up options and dual-track structures. Section 251(h) is an "opt-in" statute; it is applicable only if the merger agreement includes a provision electing § 251(h) to apply. Further, § 251(h) may not be used if the target's certificate of incorporation expressly requires a stockholder vote to approve a merger, nor may it be used to circumvent a supermajority vote or separate class vote required by the target's certificate of incorporation.

Eligibility

To be eligible to use § 251(h), the target corporation's shares must be listed on a national securities exchange or held of record by more than 2,000 stockholders immediately prior to the execution of the merger agreement. This requirement ensures that the tender or exchange offer will be subject to the informational and procedural requirements of the Williams Act.

Section 251(h) permits only corporations to serve as the acquisition vehicle. In fact, alternative entities are relatively new to short-form merger practice in Delaware with the adoption in 2010 of § 267 of the DGCL allowing an alternative entity to serve as the parent entity in a short-form merger. Limiting § 251(h) to corporate acquisition vehicles provides the Delaware General Assembly an opportunity to see how § 251(h) functions in practice before considering any proposed amendment to permit alternative entities to be § 251(h) acquisition vehicles.

Transaction Requirements

If an acquiror and the target's board of directors desire to employ § 251(h), the merger agreement must contain a provision expressly opting in to § 251(h). This opt-in requirement permits the target's board to use the inclusion of a § 251(h) provision as a negotiating tool with a potential merger partner, much in the same way targets' boards have used top-up options. Section 251(h) is not for use in hostile transactions—an agreed-upon merger agreement containing an opt-in provision must be approved by the target's board.

The merger agreement also must require the second-step merger to be effected as soon as practicable following the consummation of the first-step tender or exchange offer. This requirement addresses the statute's objective of making the merger consideration available to non-tendering stockholders quickly once the tender or exchange offer closes.

Section 251(h) also requires the first-step tender or exchange offer to be for "any and all" of the target's outstanding stock that, absent § 251(h), would be entitled to vote on the adoption or rejection of the merger agreement. The tender or exchange offer also must be made on the terms provided for in the merger agreement. In addition, the consideration paid to holders of outstanding shares in the second-step merger must be the same amount and kind as that paid in the front-end tender or exchange offer.

Third-Party Acquisitions

Section 251(h) is available for use in connection with third-party acquisitions only. No party to the merger agreement may be an interested stockholder (as defined in DGCL § 203) at the time the merger agreement is approved by the target's board. This requirement prohibits the use of § 251(h) in transactions considered more likely to involve conflicts (*e.g.*, going-private transactions). Although § 251(h) incorporates the definition of "interested stockholder" from DGCL § 203, it does not incorporate the exceptions to the business combination restrictions afforded by § 203 to stockholders who receive board approval or who have exceeded the 15% ownership threshold for longer than three years. Accordingly, such interested stockholders *cannot* take advantage of § 251(h).

Requisite Level of Support

In order to effect a second-step merger without a stockholder vote under § 251(h), the shares obtained by the acquiror in the first-step tender or exchange offer must be sufficient to satisfy the voting requirements that would apply under the DGCL if § 251(h) were not invoked. The shares obtained also must be sufficient to satisfy any high-vote provisions in the target's certificate of incorporation and any requirement for a separate class or series vote.

Fiduciary Duties

Although § 251(h) offers an efficient way to effect second-step mergers, it does not change the fiduciary duties of directors in connection with such mergers or the level of judicial scrutiny that will apply to the decision to enter into such a merger agreement, each of which will be determined based on the common law of fiduciary duty.[10]

Appraisal Rights in Stock Transactions

Previously, under DGCL § 262, appraisal rights generally were not triggered by a merger in which the consideration was publicly traded stock. Section 262 has been amended to provide that appraisal rights are available for *all* § 251(h) mergers, including those involving publicly traded stock as consideration.

Sections 204 and 205: Ratification of Defective Corporate Acts

The DGCL has also been amended to add §§ 204 and 205.[11] These two new sections provide procedures by which a Delaware corporation may ratify defective corporate acts that may otherwise be considered void or voidable under Delaware law. Under these new sections, Delaware corporations may utilize self-help procedures to ratify numerous defective corporate acts, including defective stock issuances, or seek a judicial determination of the validity of such acts.

Section 204: Ratification by the Board of Directors

Section 204 provides that "no defective corporate act or putative stock shall be void or voidable solely as a result of a failure of authorization if ratified as provided in [section 204] or validated by the Court of Chancery in a proceeding brought under [section] 205." The term "defective corporate act"[12] is intended to include *any* corporate act or transaction purportedly taken that was within the power granted to a corporation by the DGCL, but was subsequently determined to have been void or voidable for failure to comply with the applicable provisions of the DGCL, the corporation's certificate of incorporation or bylaws, or any plan or agreement to which the corporation is a party.[13]

Section 204 is intended to overturn cases such as *STAAR Surgical Company v. Waggoner*[14] and *Blades v. Wisehart*,[15] which held that defective corporate acts, transactions or stock issuances found to be void due to a failure to comply with the technical requirements of the DGCL or the corporation's governing documents may not be ratified or validated on equitable grounds. In addition, § 204 effectuates a means of cure for stock issued in excess of the number of shares the corporation is authorized to issue: § 204 expressly includes an overissuance of stock within the definition of defective corporate acts that may be ratified.[16] The new section also reconciles the DGCL with § 8-202(b) of the Delaware Uniform Commercial Code, which provides, among other things, that stock in the hands of a purchaser for value without notice of the defect is generally valid in the hands of such purchaser even if issued with a defect going to its validity.[17]

Procedures for Ratification

Under § 204, in order to ratify a defective corporate act, a board of directors must first adopt a resolution stating: (1) the defective corporate act to be ratified; (2) the time of the defective corporate act; (3) the nature of the failure of authorization in respect of the defective corporate act to be ratified; and (4) that the board of directors approves the ratification of the defective corpo-

rate act.[18] Such approval is subject to the board's quorum and voting requirements applicable to the act to be ratified at the time of ratification or, if higher, the quorum and voting requirements applicable to the act to be ratified at the time of the defective corporate act.

In addition to board action, stockholders must also ratify the defective corporate act in certain circumstances. For example, any defective corporate act resulting from a failure to comply with § 203 must be ratified by a stockholder vote. A stockholder vote is also required if such a vote is required at the time of ratification or would have been required to authorize the defective corporate act at the time the defective corporate act was taken. Such stockholder vote is subject to the stockholder quorum and voting requirements applicable to the act to be ratified at the time of ratification or, if higher, the quorum and voting requirements applicable to the act to be ratified at the time of the defective corporate act. In the case of a failure of authorization resulting from failure to comply with § 203, ratification of the defective corporate act requires the vote set forth in § 203(a)(3), regardless of whether such vote otherwise would have been required.

In addition, when a stockholder vote is required, advance notice must be given to both current holders of the corporation's valid and putative stock as well as to the holders of the corporation's valid and putative stock at the time of the defective corporate act, unless such holders cannot be determined from the corporation's records. In situations where no stockholder vote is required for ratification, notice to such stockholders must be given following the adoption of the board's ratifying resolution.

Once the requisite board approval and, if required, stockholder approval have been obtained, a certificate of validation must be filed with the Delaware Secretary of the State if the act being ratified would have required a similar filing. Ratification becomes effective upon the filing of such certificate, unless otherwise determined in an action brought pursuant to § 205, as described below.

Importantly, ratification of a defective corporate act under § 204 is designed to remedy the technical validity of the act or transaction; it is not intended to modify the fiduciary duties applicable to either the approval or effectuation of a defective corporate act or transaction or any ratification of such act or transaction.[19] Defective corporate acts, even if ratified under § 204, remain subject to traditional fiduciary and equitable review.

Section 205: Validation by the Court of Chancery

Section 205 confers jurisdiction on the Court of Chancery to hear and determine the validity of any defective corporate act that has not been ratified or ratified effectively pursuant to § 204, regardless of whether the defective corporate act would have been capable of ratification pursuant to § 204. In proceedings commenced pursuant to § 205, the statute provides that the Court of Chancery may, among other things: (i) determine the validity of a § 204 ratification and the defective corporate act that is the subject of such ratification; (ii) determine the validity of a defective corporate act that is not the subject of a § 204 ratification; (iii) require measures to remedy, or avoid, certain harms to persons substantially and adversely affected by a § 204 ratification; (iv) approve a stock ledger that includes any stock ratified or validated under the new procedures; or (v) order that a stockholder meeting be held. An action under § 205 may be brought by the corporation or any member of its board or its stockholders (including holders of putative stock), as well as other persons claiming to be substantially and adversely effected by a § 204 ratification.

Section 205 also provides that in any proceeding commenced pursuant to § 205, the Court of Chancery may consider a number of factors, including: whether the defective corporate act was originally approved or effectuated with the belief that the approval or effectuation was in compliance with the provisions of the DGCL, the certificate of incorporation or bylaws of the corporation; whether the corporation and board of directors have treated the defective corporate act as a valid act or transaction and whether any person has acted in reliance on

the public record that such defective corporate act was valid; and whether any person will be harmed by ratification, or by the failure to ratify or validate the defective corporate act. These factors are not exhaustive.

Section 205 further provides that if a defective corporate act or putative stock is ratified in accordance with § 204, then no person to whom notice of ratification was provided may assert a claim challenging ratification, unless, with certain exceptions, that claim is asserted within 120 days from the effective time of the ratification.

The procedures set forth in §§ 204 and 205 are not intended to preempt or restrict other valid means of ratifying any corporate act or transaction, including any defective corporate act, that would otherwise be voidable but not void.[20] Thus, for example, the general doctrine of ratification, as recognized by the Court of Chancery in *Klig v. Deloitte LLP*,[21] and *Kalageorgi v. Victor Kamkin, Inc.*,[22] and applied to a board's adoption of acts taken by officers who may not have had the actual authority to take such acts, will continue to be an effective mode of ratification in the appropriate circumstances. Likewise, the doctrine of "shareholder ratification" described in *Gantler v. Stephens*,[23] will continue to be an effective mode of ratification.

Conclusion

Section 251(h) provides a cost-effective procedure to consummate promptly a two-step acquisition whenever a corporate acquisition vehicle acquires sufficient shares in a first-step tender or exchange offer to ensure that a second-step long-form merger will be approved, while preserving the existing substantive and procedural protections afforded to a target's stockholders. The associated cost savings and ability to expedite receipt of the merger consideration by the target's non-tendering stockholders enhance acquirors' ability to rely on a two-step transaction structure.

Section 204 provides Delaware corporations a means to ratify defective corporate acts where the corporation is able to obtain, at the time of ratification, the approvals that would have been necessary at the time of the defective corporate act. Section 205 provides the Court of Chancery a statutory mechanism to validate defective corporate acts—or invalidate the ratification thereof—upon application by the corporation, its stockholders or other persons.

NOTES

1. H.B. 127, 147th Gen. Assembly, 79 Del. Laws, c. 72, § 6 (2013).
2. 79 Del. Laws, c. 72, §§ 4, 5.
3. 79 Del. Laws, c. 72, §§ 3, 14, 19. Additional legislation, providing for the creation of "public benefit corporations," was signed into law on July 17, 2013. *See* S.B. 47, 147th Gen. Assembly, 79 Del. Laws, c. 122, § 8 (2013).
4. *See In re Cogent, Inc. S'holder Litig.*, Consol. C.A. No. 578-VCP, slip op. at 27-28 (Del. Ch. Oct. 5, 2010) (noting "[t]op-up options have become commonplace in two-step tender offer deals"); *Olson v. EV3, Inc.*, C.A. No. 5583-VCL, trans. at 31 (Del. Ch. June 25, 2010) (stating that the use of top-up options has "skyrocketed").
5. For additional information about the use of top-up options, *see* Edward B. Micheletti & Sarah T. Runnells Martin, *The Rise and (Apparent) Fall of the Top-Up Option 'Appraisal Dilution' Claim*, The M&A Lawyer (Jan. 2011).
6. *See Olson v. EV3, Inc.*, trans. at 26 (explanation by counsel that 20% of the number of shares outstanding must be issued under a top-up option to raise purchaser's holdings 2%, from 88% to 90%, and 150% of the number of shares outstanding must be issued to raise purchaser's holdings 15%, from 75% to 90%).
7. Once a tender offer is commenced, Exchange Act Rule 14e-5 prohibits an offeror or its affiliates from purchasing or arranging to purchase securities until the tender offer expires. However, Rule 14e-5 does not apply to preliminary proxy statements or definitive proxy statements filed during a subsequent offering period. Thus, if an offeror files a preliminary proxy statement shortly after a tender offer is commenced, the offeror may file a definitive proxy statement, if necessary, during a subsequent offering period if the SEC comment period has expired.
8. It is unclear whether the dual-track structure would permit the stockholders meeting to be held simultaneously with the closing of the tender or exchange offer. The ability to do so depends on the timing of SEC review of the proxy statement, if any.
9. 79 Del. Laws, c. 72, § 6.
10. *Id.*
11. Sections 204 and 205 will not become effective until April 1, 2014.

12. 8 Del. C. § 204(h)(1).
13. 79 Del. Laws, c. 72, § 4.
14. 588 A.2d 1130, 1136 (Del. 1991) ("Stock issued without authority of law is void and a nullity.").
15. C.A. No. 5317-VCS, 2010 WL 4638603, at *10 (Del. Ch. Nov. 17, 2010) (explaining that "scrupulous adherence to corporate formalities are germane to a board's adoption of a stock split because both board actions involve a change in the corporation's capital structure").
16. For purposes of §§ 204 and 205, overissued shares are those issued in excess of the number permitted by section 161 at the time the shares in question are issued.
17. *See Noe v. Kropf*, C.A. No. 4050-CC, trans. at 13 (Del. Ch. Jan. 15, 2009) (explaining that shares were void when issued, and "any action taken where authority is lacking will constitute more than a mere defect as contemplated by § 8-202(b)(1). [Purchaser] purchased shares that in effect never existed. Therefore, [Purchaser] is not entitled to any protection under the Delaware Uniform Commercial Code.").
18. If such defective corporate act involved the issuance of shares of putative stock (*i.e.*, shares of stock that but for a failure of authorization would have been validly issued and any other shares that the board of directors cannot determine to be valid stock), the resolution must also state the number and type of shares of putative stock issued and the date or dates upon which such putative shares were purported to have been issued. The procedures of section 204 are not available if a corporation does not have a valid board of directors. 79 Del. Laws, c. 72, § 4. If there is no valid board, relief would need to be sought under § 205. *Id.*
19. 79 Del. Laws, c. 72, § 4.
20. *Id*.
21. 36 A.3d 785 (Del. Ch. 2011).
22. 750 A.2d 531(Del. Ch. 1999), *aff'd*, 748 A.2d 913 (Del. 2000) (unpublished table decision).
23. 965 A.2d 695 (Del. 2009).