

Sections 204 and 205 of Delaware Corporation Law: Effective Tools to Remedy Defective Corporate Acts

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> See page 4 for key takeaways

Since they became effective in 2014, Sections 204 and 205 of the Delaware General Corporation Law (DGCL) have provided mechanisms for a corporation to unilaterally ratify defective corporate acts or seek relief from the Court of Chancery to validate any corporate act under certain circumstances. These provisions filled a perceived gap in the DGCL. Prior to their enactment, a corporation had no tool to fix defective acts or obtain validation of issues causing uncertainty in corporate documents, actions or otherwise. So far, the Court of Chancery has had relatively few opportunities to opine on the use of these statutory provisions.

Purpose and Use of Sections 204 and 205

Before Sections 204 and 205 were added to the DGCL, Delaware case law held that defective corporate acts, transactions or stock issuances that were void or voidable due to a failure to comply with the technical procedural requirements of the DGCL or the corporation's governing documents could not be retroactively ratified or validated on equitable grounds.¹ Sections 204 and 205 provide a practical way to resolve defective corporate acts and other uncertainties facing Delaware corporations "without disproportionately disruptive consequences."²

Section 204 is a self-help statute, *i.e.*, ratification can be accomplished without court involvement. Section 204(a) sets forth a road map for a board to remedy what would otherwise be void or voidable corporate acts and stock issuances, and provides that "no defective corporate act³ 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." Pursuant to Section 204, a corporation's board of directors may ratify one or more defective corporate acts by adopting resolutions setting forth the defective corporate act to be ratified, the date on which that act occurred, the reason why it is defective and that the board has approved the ratification of the defective corporate act or acts. A stockholder vote also is required to ratify the defective act if such a vote was required either at the time of the defective corporate act or at the time the board adopts the resolutions ratifying such act.

Section 205 envisions court involvement and allows a corporation, on an *ex parte* basis, to request that the court determine the validity of any corporate act (defective or not) or transaction and any stock, rights or options to acquire stock. Section 205 empowers the court to craft and grant an equitable remedy to validate corporate acts that once "would have been void at law and unreachable

¹ See, e.g., *Blades v. Wisehart*, C.A. No. 5317-VCS, 2010 WL 4638603, at *8 (Del. Ch. Nov. 17, 2010) (requiring "scrupulous adherence to statutory formalities when a board takes actions changing a corporation's capital structure"); *STAAR Surgical Co. v. Waggoner*, 588 A.2d 1130, 1136 (Del. 1991) ("Stock issued without authority of law is void and a nullity.")

² *In re Numoda Corp. S'holders Litig.*, Consol. C.A. No. 9163-VCN, 2015 WL 402265, at *8 (Del. Ch. Jan. 30, 2015).

³ A "defective corporate act" includes any corporate act or transaction that was within the power granted to a corporation by the DGCL but was thereafter determined to have been void or voidable for failure to comply with the applicable provisions of the DGCL, the corporation's governing documents, or any plan or agreement to which the corporation is a party. See 8 Del. C. § 204(h)(1).

at equity.”⁴ While the statutory language of Section 205 confers substantial discretion and flexibility upon the court to validate certain corporate acts, the court “exercises its powers carefully”⁵ and has declined to simply rubber-stamp Section 205 applications without serious consideration of the corporate act at issue and whether the request for validation is a proper use of the statute.

Court’s Exercise of Power to Validate Defective Corporate Acts

While Section 204 “facilitates self-help,” Section 205 is “for situations where judicial intervention is preferable or necessary.”⁶ For the first year that Section 205 was in effect, parties sought validation from the court largely relating to issues concerning the existence of corporations, such as confirming the composition of a corporation’s board of directors⁷ and validating defective stock issuances.⁸

However, in 2015, in *In re Genelux Corp.*, then-Vice Chancellor Donald F. Parsons, Jr. was asked to exercise the court’s power under Section 205 to invalidate a purportedly defective corporate act.⁹ Genelux sought invalidation of the issuance of 1.5 million shares of its preferred stock to one of its founders because such stock was purportedly issued without authorization and consideration. Genelux argued that because the court may “[d]etermine the validity of any corporate act or transaction and any stock, rights or options to acquire stock” under Section 205(a)(4), it may therefore also determine that such stock is invalid. Vice Chancellor Parsons decided that the plain language of Section 205 was ambiguous and therefore looked to extrinsic evidence,

⁴ *Numoda*, 2015 WL 402265, at *7.

⁵ *Id.* at *10.

⁶ *Id.* at *7.

⁷ See *In re Certisign Holding, Inc.*, C.A. No. 9989-VCN, 2015 WL 5136226 (Del. Ch. Aug. 31, 2015); *In re Colfax Corp.*, C.A. No. 10447-VCL (Del. Ch. Apr. 2, 2015) (TRANSCRIPT); *Numoda*, 2015 WL 402265.

⁸ See *In re Wine.com, Inc.*, C.A. No. 10401-VCG (Del. Ch. Apr. 16, 2015) (TRANSCRIPT); *In re Cheniere Energy, Inc.*, C.A. No. 9766-VCL (Del. Ch. Aug. 26, 2014) (TRANSCRIPT); *In re Trupanion, Inc.*, C.A. No. 9496-VCP (Del. Ch. Apr. 28, 2014) (TRANSCRIPT).

⁹ 126 A.3d 644, 663 (Del. Ch. Oct. 22, 2015), *vacated in part on other grounds by Genelux Corp. v. Roeder*, 143 A.3d 20 (Del. 2016) (TABLE).

including the legislative synopsis, commentary in a Delaware law treatise and other provisions in Section 205 to determine the statute’s intended meaning.

Based on this analysis, Vice Chancellor Parsons held that Section 205 “fundamentally concerns a company having taken an act with the intent and belief that it is valid and later petitioning the Court to correct a technical defect and thereby remedy incidental harm.” Accordingly, Vice Chancellor Parsons held that Section 205 does not permit the invalidation of purportedly defective corporate acts.

Court’s Exercise of Power to Validate Nondefective Corporate Acts

In *In re Baxter Int’l Inc.*,¹⁰ Chancellor Andre G. Bouchard determined an issue of first impression and validated a corporate act that was not “defective.” The company’s charter included a classified board provision that required amendment by a super-majority vote. Due to uncertainty regarding whether the language of this provision called for a per-capita or per-share vote, the company’s board adopted a resolution stating that it had determined to count votes to amend that provision of the charter on a per-share basis, notwithstanding that it had counted votes on previous amendments on a per-capita basis. The company held the vote at its annual stockholders meeting and, pursuant to its resolution, counted the votes on a per-share basis. The company easily obtained the requisite votes to amend the charter and thereafter filed the amendment with the secretary of state. The company then filed an application requesting that the court validate the charter amendment under Section 205(a)(4), which authorizes the court to determine the validity of any corporate act.¹¹

¹⁰ C.A. No. 11609-CB (Del. Ch. June 22, 2016) (TRANSCRIPT).

¹¹ As directed by Chancellor Bouchard, the company gave notice to stockholders in a Form 8-K, but none came forward to challenge the Section 205 application. In addition, although Section 205 relief may be sought through a nonadversarial proceeding, Chancellor Bouchard appointed special counsel to create an adversarial context.

Chancellor Bouchard granted the requested relief, accepting the company's argument that Section 205 is not limited to only defective corporate acts. In his ruling, Chancellor Bouchard considered factors he deemed just and equitable, including that there had "been a history of uncertainty surrounding [the classified board] provision," "the fact that it appears logistically impracticable to make this amendment otherwise" and "the equities favor a per-share voting presumption, which protects the holders of a majority of shares from being disenfranchised." The court also noted that the company had "thoroughly disclosed its decision to count the votes on a per-share basis rather than a per-shareholder basis."

Court's Recent Views on Section 204 Ratification Issues and Resulting 205 Applications

Earlier this year, the Court of Chancery reviewed two actions that highlight potential issues with ratification under Section 204, and related stockholder litigation and Section 205 applications: *Steinberg v. Townley* and *Almond v. Glenhill Advisors LLC*.¹² In both cases, the issue with the Section 204 ratifications related to potentially self-interested board members who purported to have ratified the defective corporate acts.

In *Steinberg*, Wikipad's two-member board of directors took action under Section 204 to ratify a number of defective corporate acts — specifically, improperly approved charter amendments pursuant to which unauthorized stock was issued, which affected the capitalization of the company — and adopted resolutions reflecting those actions. Wikipad stockholders subsequently initiated an action challenging the Section 204 process, claiming that because the resolutions lacked transparency and the directors used the ratification process to implement acts of self-dealing, the directors were unable to properly ratify such acts. Ultimately, the parties reached a settlement on the claims regarding the Section 204 process

that resulted in an agreed-upon capitalization table. Thereafter, the parties sought approval of the settlement agreement and jointly moved under Section 205 for validation of the capitalization table.

Vice Chancellor J. Travis Laster validated Wikipad's capitalization table but expressed concern about "inducing a regime where [Section] 205 becomes a new rubber-stamp opportunity for people to shift responsibility [to the Court]." To avoid such a result, Vice Chancellor Laster opined that, if possible, parties should attempt to fix defective corporate acts unilaterally through ratification under Section 204 instead of seeking court approval in the first instance. Because the parties in *Steinberg* had done just that, Vice Chancellor Laster decided that "it would be unfair to the parties who have litigated this matter in this Court not to get the judicial resolution that [Section] 205 ... can provide." In addition, Vice Chancellor Laster was persuaded by the parties' representation that if they were required to complete another Section 204 process to ratify the capitalization table, the delay caused by the requisite 120-day notice period would have harmed Wikipad, which needed to secure financing as soon as possible in order to continue doing business.

In *Glenhill*, Herman Miller, Inc. stockholders challenged Herman Miller's acquisition of Design Within Reach (DWR), contending that the acquisition was never consummated due to a number of technical mistakes, primarily that DWR allegedly failed to complete a reverse stock split upon acquisition by Herman Miller, which, if true, meant that Herman Miller owned less than the requisite 90 percent of DWR stock to effectuate a short-form merger. The plaintiffs argued that, as a result, all acts and transactions occurring after the unsuccessful stock split were invalid, including the merger itself.

In response, DWR's board ratified the stock issuances under Section 204, including the original reverse stock split. The ratification was subsequently approved by DWR's stockholders acting by written consent. Thereafter, Herman Miller answered the complaint and asserted several affirmative defenses, including that the

¹² *Steinberg v. Townley*, C.A. No. 12539-VCL (Del. Ch. Feb. 27, 2017) (TRANSCRIPT); *Almond v. Glenhill Advisors LLC*, C.A. No. 10477-CB (Del. Ch. Jan. 31, 2017) (TRANSCRIPT).

complaint failed to state a claim because the purportedly defective acts had been ratified. Also, DWR intervened in the action and, along with Herman Miller, sought Section 205 relief through a counterclaim, requesting validation of its ratification of the alleged defective stock issuances. Herman Miller and DWR then moved for partial summary judgment on their Section 205 counterclaim/request.

Chancellor Bouchard denied the motion, noting that “[t]his is not your plain vanilla ... clean mistake case,” because three members of

the six-member board who participated in the Section 204 ratification process had a personal financial interest in the underlying transaction, raising concerns of self-dealing that potentially infected the ratification process. Chancellor Bouchard ordered a prompt trial, noting that he was concerned with the incomplete state of discovery and “need[ed] to see the whole picture before [he could] pull the trigger on blessing [the ratified acts].”

Key Takeaways

Sections 204 and 205 appear to be effective mechanisms to fix issues and obtain validation of corporate acts from the Court of Chancery that ultimately provide certainty and stability for Delaware corporations. Although the case law construing these provisions is still developing, key takeaways from the court’s early rulings include:

- Parties should consider attempting to engage in self-help facilitated by Section 204 by ratifying the corporate act at issue before seeking Section 205 relief from the court.
- To the extent Section 204 is not available or applicable, the court may be amenable to a unilateral Section 205 application.
- The court has indicated that it will not rubber-stamp Section 205 applications but instead will give serious consideration to whether granting such relief is necessary and an appropriate use of the court’s power under the statute.
- At least one member of the court has recognized that Section 205 is not limited to defective corporate acts. Therefore, a corporation may seek validation of any corporate act, which the court may grant under certain circumstances.

In sum, Sections 204 and 205 have the potential to be effective tools that corporations and their counsel may employ in appropriate situations to remedy defective corporate acts or provide clarity on issues that, while not necessarily defective, may be causing corporate uncertainty.

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