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Skadden Discusses Proposed Changes to Delaware Corporation Law

By Allison L. Land and Edward B. Micheletti May 30, 2023

Comment

The proposed 2023 amendments to the Delaware General Corporation Law (DGCL) approved by the Delaware State Bar Association are intended to address a number of practical issues facing corporations and their counsel and to facilitate certain corporate actions. Among other things, the proposed amendments would:

- Streamline procedures for ratifying defective corporate acts.
- Provide a safe harbor from stockholder approval requirements for certain dispositions of pledged assets.
- Eliminate or reduce the stockholder approval requirement to effect certain stock splits and changes in the number of a corporation's authorized shares.

The Delaware Senate passed the proposed DGCL amendments on May 16, 2023 and, if adopted by the Delaware House of Representatives at a hearing expected to be held in June and signed into law by Delaware's governor, they would become effective August 1, 2023.

Ratification of Defective Corporate Acts

DGCL Section 204 was adopted in 2014 to provide corporations with a self-help mechanism to ratify defective corporate acts, including stock issuances, that otherwise are void or voidable due to a failure to duly authorize such acts.

In practice, however, the ratification procedure under Section 204 has proven to be a burdensome and time-consuming process, significantly limiting its utility, particularly in public offerings and M&A transactions, where resolution of such issues must be completed prior to closing. In such cases, parties are sometimes forced to pursue a court-ordered ratification under Section 205, or avail themselves of another self-help mechanism.

The proposed amendments are intended to revitalize Section 204 by streamlining and simplifying the ratification process, which would promote use of this self-help mechanism. Increased use of Section 204 would ease the burden on the Court of Chancery by reducing the number of ratification proceedings brought under Section 205 that otherwise can be resolved under Section 204 without court involvement.

A key element of amended Section 204 is eliminating the requirement to file a certificate of validation with the Secretary of State in many situations. As amended, filing a certificate of validation would be required only if the defective corporate act to be ratified required the filing of a certificate under any DGCL section and such certificate either was never filed or was filed but must be changed to give effect to the ratification (including a change in such certificate's effective time).

Even when a certificate of validation still must be filed, the proposed amendments would simplify and streamline the process by significantly reducing the level of detail and narrative that must be set forth in the certificate. This would have the additional intended benefit of reducing the amount of information that must be reviewed by the Secretary of State's office to accelerate its processing of certificates of validation.

The proposed amendments also address the uncertainty in determining which stockholders (if any) are entitled to vote on a ratification, by clarifying that it is all holders of shares of valid stock outstanding and entitled to vote at the time the board adopts resolutions ratifying the defective corporate act.

Safe Harbor for Certain Dispositions of Pledged or Mortgaged Assets

For some time, practitioners have debated whether there is an "insolvency exception" from the stockholder approval requirement of DGCL Section 271 for a sale of all or substantially all a corporation's assets that would permit an insolvent corporation to sell its assets without stockholder approval. In its recent decision in *Stream TV Networks, Inc. v. SeeCubic, Inc*., 279 A3d 323 (Del. 2022), the Delaware Supreme Court settled this debate, noting that "a common law insolvency exception, if one ever existed in Delaware, did not survive the enactment of Section 271" and that, accordingly, "there is no Delaware common law 'board only' insolvency exception under Section 271." (*Stream TV*, 279 A3d at 337.)

The proposed amendments to DGCL Section 272 would provide Delaware corporations with a safe harbor from the Section 271 stockholder approval requirement in connection with dispositions of property or assets subject to a mortgage or pledge if certain conditions are satisfied. The proposed amendments, however, do not purport to overrule the Supreme Court's decision in *Stream TV*, nor would they create a general insolvency exception to Section 271.

Specifically, amended Section 272(b) would permit a corporation, without stockholder approval, to sell, lease or exchange its property or assets subject to a mortgage or pledge, but only if the secured party has the right under applicable law to sell, lease or exchange the secured property or assets without the corporation's consent, and either:

> (i) the secured party exercises such right or
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> (ii) in lieu of the secured party exercising such right, the board of directors authorizes an alternative transaction involving a sale, lease or exchange of the secured property or assets, either with the secured party or with another person, that reduces or eliminates the liabilities or obligations secured by such property or assets, but only if:
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> 1. the value of the secured property or assets to be disposed of does not exceed the amount of liabilities or obligations reduced or eliminated as a result of such alternative transaction; and
> 2. such transaction is not prohibited by the law governing the secured party's mortgage or pledge.

No particular valuation methodology would be prescribed for determining the value of the secured property or assets under clause (a), and an alternative transaction would not fail to satisfy such requirement solely because consideration is paid to the corporation or its stockholders. Any failure to satisfy such requirement would not result in the invalidation of the alternative transaction once it is consummated so long as the transferee provided value and acted in good faith. However, claims seeking to enjoin an alternative transaction before its consummation, and claims seeking monetary damages, would not be precluded, including claims based on breach of fiduciary duties (subject to available defenses).

Notably, to the extent that a provision of the corporation's certificate of incorporation requires stockholder approval for a sale of all or substantially all the corporation's assets, such provision would not require stockholder approval for a transaction permitted by amended Section 272(b), unless such provision expressly requires approval for such a transaction and first becomes effective after August 1, 2023. Accordingly, a review of any such stockholder approval requirements in existing certificates of incorporation is recommended to determine whether an amendment is desired to effectively "opt out" of Section 272(b).

Authorization of Stock Splits and Changes in the Number of Authorized Shares

Corporations effect stock splits to increase or decrease the number of issued shares of their stock by a specified ratio without changing their total market capitalization, including in connection with public offerings or when they are facing a potential delisting of their stock. In a forward stock split, each issued share is subdivided into a greater number of shares, and in a reverse stock split, each issued share is combined into a smaller number of shares. In connection with a stock split, and in a variety of other circumstances, a corporation may seek to amend its certificate of incorporation to increase or decrease the number of authorized shares of the class of stock. Any such amendment to the certificate of incorporation must be authorized in accordance with DGCL Section 242.

Under Section 242(b), an amendment to the certificate of incorporation must be authorized by the board of directors and, subject to limited exceptions, adopted by holders of a majority of the outstanding stock entitled to vote thereon and, to the extent applicable, by holders of a majority of the outstanding stock of each class of stock entitled to vote thereon as a separate class. Any proposed amendment that would increase or decrease the number of authorized shares of a class of stock requires a separate class vote of the holders of that class of stock, whether or not entitled to vote thereon under the certificate of incorporation, unless such separate class vote is denied by a provision of the certificate of incorporation.

Forward Stock Splits and Related Increases in the Number of Authorized Shares

Forward stock splits often occur in connection with a public or other offering of shares in order to adjust the number of outstanding shares in light of demand and pricing of the offering, typically shortly before closing. Seeking stockholder approval after pricing of the offering is often impractical and, accordingly, a practice has developed in which the board of directors approves a variety of ratios for the forward split and seeks stockholder approval for charter amendments at several alternative ratios in advance of pricing. The board then selects which ratio to implement once pricing is completed. Because

all outstanding shares of the class of stock subject to a forward stock split are increased by the same ratio, there is no economic, voting or other impact of a forward stock split on the holders of such shares.

The proposed amendments include a new Section 242(d) that would eliminate the requirement for stockholder approval to amend the certificate of incorporation to effect forward stock splits, except if otherwise required by the certificate of incorporation, if the corporation only has one class of stock outstanding that is not subdivided into series. In connection with forward stock splits, the certificate of incorporation is typically amended to also increase the number of authorized shares of the class of stock subject to the forward split, to retain the same ratio of authorized to outstanding shares of such class of stock. Under new Section 242(d), if a forward stock split is authorized without stockholder approval, the certificate of incorporation also may be amended without stockholder approval to increase the number of authorized shares of the same class of stock, up to an amount proportionate to the stock split ratio, unless stockholder approval is required by the certificate of incorporation.

These amendments to Section 242 would facilitate public offerings and bring the DGCL in line with the prevailing law governing forward stock splits and related increases in authorized shares in a majority of U.S. jurisdictions.

Reverse Stock Splits and Other Changes to the Number of Authorized Shares

Section 242(d) also would modify the stockholder voting requirement to amend the certificate of incorporation to effect a reverse stock split or to increase or decrease the number of authorized shares of a class (other than as described above in connection with forward stock splits).

These amendments are intended to address the increasing challenges faced by many corporations in obtaining stockholder approval by a majority of outstanding shares, particularly in light of recent trends relating to broker non-votes. For most public companies, a majority of outstanding shares is held by brokers and other record holders in “street name.” Under stock exchange rules, brokers and other record holders who have not received voting instructions from beneficial holders have discretionary authority to vote such shares only on “routine” proposals, such as the appointment of a corporation’s auditors, but may not exercise their discretion to vote such shares on matters considered to be “non-routine.” Because the required stockholder vote to amend the certificate of incorporation is not considered a “routine” matter and requires approval by a majority of all outstanding shares entitled to vote thereon, the effect of a broker non-vote is essentially the same as a vote against such proposal.

Under the proposed amendments, unless otherwise required by the certificate of incorporation, the stockholder voting requirement would be decreased, from a majority of outstanding shares to a majority of the votes cast (thus causing abstentions to have no effect on the vote), to amend the certificate of incorporation to effect a reverse stock split of a class of stock, or to increase or decrease the number of authorized shares of a class of stock, but only if such class of stock is listed on a national securities exchange and the corporation would continue to meet the listing requirement relating to the minimum number of holders immediately after giving effect to such amendment.

Specifically, new Section 242(d) would require such an amendment to the certificate of incorporation to be approved by:

> (i) a vote of all stockholders entitled to vote thereon, voting as a single class, in which the cast votes cast in favor of such amendment exceed the votes cast against, and
>
> (ii) solely in connection with an increase or decrease in the number of authorized shares of a class, holders of such class of stock, voting as a separate class, cast more votes in favor of such amendment than against, unless the corporation’s certificate of corporation has opted out of such separate class vote requirement pursuant to Section 242(b)(2).

The proposed amendments to Section 242 permit a corporation’s certificate of incorporation to “opt in” to the majority-of-outstanding-shares voting standard presently in effect under Section 242(b) for amendments to the certificate of incorporation to effect forward or reverse stock splits, or to increase or decrease the number of authorized shares, by expressly stating that the stockholder vote otherwise required under Section 242(b) is required to approve such matter, or by expressly opting out of some or all of the provisions of new Section 242(d).

Stockholder Notice

The proposed amendments to DGCL Section 228 would simplify the determination of the record date for stockholders entitled to receive notice of action by consent of stockholders. Under amended Section 228(e), notice of action by consent must be given to persons who:

> (i) were stockholders as of the record date for such action by consent,
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> (ii) would have been entitled to notice of the stockholders’ meeting if such action had been taken at a meeting and the record date for notice of such meeting were the same as the record date for such action by consent, and
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> (iii) have not consented to such action.

The proposed amendments also would permit corporations entitled to use a notice of internet availability of proxy materials under federal securities laws to use such notice to satisfy Section 228(e).

This post comes to us from Skadden, Arps, Slate, Meagher & Flom LLP. It is based on the firm's memorandum, "Proposed Changes to Delaware Law Would Facilitate Ratification of Defective Corporate Acts, Disposition of Pledged Assets, Stock Splits and Changes to the Number of Authorized Shares," dated May 25, 2023, and available here.