Analysis of the 2013 Amendments to the Delaware General Corporation Law

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ANALYSIS OF THE 2013 AMENDMENTS TO THE DELAWARE GENERAL CORPORATION LAW

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Significant amendments to the Delaware General Corporation Law ("DGCL") were adopted in 2013. Most notably, the amendments (1) permit certain mergers following tender offers to be completed without any stockholder vote, even if the acquiror holds less than the 90% stock ownership necessary for a "short form" merger, (2) permit the formation of a new kind of Delaware corporation, the "public benefit corporation," which is specifically designed to promote identified public benefits in addition to stockholder interests, and (3) permit the ratification of certain prior corporate actions, such as stock issuances or charter amendments, which might otherwise be void or voidable under Delaware case law if the original authorization of such actions was not in strict compliance with statutory requirements. The Delaware statute on stock issuance was also amended to clarify that the price fixed by the board of directors for a stock issuance may be based on a formula, such as the market price over a period of time. Various minor and conforming changes to other sections of the DGCL were made as well, including to the appraisal statute, a copy of which must be provided to stockholders in connection with most mergers. The amendments take effect on August 1, 2013, except for the "ratification amendments" discussed above, which do not take effect until April 1, 2014.[1]

CONSIDERATION FOR ISSUANCE OF STOCK

Issuance of stock; lawful consideration; fully paid stock [§ 152].—Section 152 requires the board of directors to determine the consideration for the issuance of the corporation's stock. The statute already gives the board wide discretion in this regard, permitting the consideration to be "cash, any tangible or intangible property or any benefit to the corporation, or any combination thereof." However, an additional sentence is being added to clarify that the board may also determine the amount of the consideration to be required for a stock issuance by approving a formula by which the amount of consideration is determined. For example, a board could approve the issuance of stock for a price based on the average of the market price of the corporation's shares over a specified period.

RATIFICATION AND VALIDATION OF DEFECTIVE CORPORATE ACTS

Ratification of defective corporate acts and stock [§ 204].—A new Section 204 has been added to the DGCL to enable corporations to ratify prior corporate acts that would be void or voidable under Delaware case law due to flaws in the original

1. This article supplements prior reports published by Aspen Publishers and its predecessor, Prentice Hall Law & Business, describing amendments to the Delaware General Corporation Law enacted in each of calendar years 1967; 1969; 1970; 1973-74; 1976; 1981; 1983-1988; and 1990-2012. The authors of one or more of the prior reports are: Samuel Arsht; Walter K. Stapleton; Lewis S. Black, Jr.; A. Gilchrist Sparks, III; Frederick H. Alexander; Jeffrey R. Wolters; and James D. Honaker.

authorization of such acts by the corporation's board of directors or stockholders. Section 204 is a "self-help" statute that essentially allows a corporation to "redo" a flawed authorization – for example, a prior approval of a charter amendment by the board or stockholders which did not comply strictly with the statutory requirements for such approvals. In addition to the ratification of prior defective acts permitted by Section 204, new Section 205 of the DGCL, discussed below, also allows judicial "validation" of such acts. Section 205 is available if Section 204 cannot be used (for example, if the corporation does not have a functioning board) or if a party prefers to seek judicial imprimatur for (or against) a prior act.

Both sections were developed in response to – and in fact, as stated in the legislative synopsis, specifically to overturn – Delaware case law that has held certain prior unauthorized corporate acts to be void or voidable regardless of the equities of the case. *See, e.g.*, *STAAR Surgical Co. v. Waggoner*, 588 A.2d 1130 (Del. 1991); *Blades v. Wisehart*, 2010 WL 4638603 (Del. Ch. Nov. 17, 2010). The new sections also help implement certain preexisting provisions of the Delaware Uniform Commercial Code, such as Section 8-210 (cure for overissue of stock) and Section 8-202(b) (providing that defective stock is generally valid in the hands of a good faith purchaser for value without notice of the defect), notwithstanding certain authority suggesting that the provisions of the Delaware Uniform Commercial Code cannot validate stock that is void under the Delaware General Corporation Law. *See Noe v. Kropf*, C.A. No. 4050-CC (Del. Ch. Jan. 15. 2009) (Transcript).

Section 204 sets forth specific steps that must be followed in order to ratify a prior unauthorized act, including an issuance of "putative stock" (the statutory term for stock whose issuance was not properly authorized). These steps essentially involve (1) board approval of the ratification; (2) stockholder approval of the ratification if stockholder approval was required at the time of the original act (or is required at the time of ratification); and (3) notice to all stockholders, and all holders of putative stock, within 60 days of the board's approval of the ratification regardless of whether stockholder approval is required. If these steps are followed, then generally no claim asserting that the original act is void or voidable due to defective authorization, or that the Court of Chancery should declare in its discretion that a ratification was ineffective, may be brought after 120 days from the date of the notice of ratification or, if required, the filing with the Delaware Secretary of State noted below. If the steps required by Section 204 cannot be followed – for example, if board approval of the ratification cannot be obtained because there is not a validly elected board of directors in place, or if stockholder approval (if required) cannot be obtained from the holders of valid shares (as opposed to putative shares, which are not entitled to vote) – then the corporation may resort to Section 205 to ask the Court of Chancery to give its approval of the prior defective act or to waive any requirement of Section 204. Importantly, the legislative synopsis also makes clear that Sections 204 and 205 only address the technical validity of prior defectively-authorized acts, and do not affect fiduciary duties or any equitable claims against such acts, and that the new statutes do not preclude other means of ratification, such as under the common law. *See, e.g.*, *Klig v. Deloitte LLP*, 36 A.3d 785 (Del. Ch. 2011); *Kalegeorgi v. Victor Kamkin, Inc.*, 750 A.2d 531 (Del. Ch. 1999), *aff'd* 748 A.2d 913 (Del. 2000) (unpublished table decision).

Turning to Section 204's requirement of board approval, the board must adopt resolutions that specifically identify and ratify the defective act or putative stock in question, including certain specific elements such as the nature of the defect and the date of issuance of any putative stock. The quorum and voting requirements for the board "look back" to the time of the defective act if such requirements were more onerous at such time.

Section 204 next requires stockholder approval of the ratifying resolutions adopted by the board if stockholder approval of the defective act either is, or was at the time of the original defective act, required under the DGCL, the company's charter or bylaws, or any applicable plan or agreement, or if the defect resulted from a failure to comply with Section 203 of the DGCL (Delaware's anti-takeover statute). Section 204(d) requires that 20 days' notice of the stockholder meeting to vote on the ratification be sent to all holders of valid and putative stock. This notice must be sent to such holders both as of the record date for the meeting and as of the time of the original defective act. The notice must specifically alert stockholders to the 120-day statute of limitations on claims attacking the defective act. Similar to the quorum and voting requirements for the board, such requirements for the stockholder vote look back to the time of the defective act if such requirements were more onerous at such time.

If stockholder approval is not required and therefore the notice required by Section 204(d) has not been sent – or if such notice has not been sent because the requisite stockholder approval was obtained by written consent without a meeting under Section 228 of the DGCL – the corporation must still provide a notice similar to the Section 204(d) notice within 60 days of the board's adoption of the ratifying resolutions. Thus, even if stockholders will not have the opportunity to vote on the ratification, holders of valid or putative shares will receive notice and will be able to file suit in the Court of Chancery to object to the ratification under Section 205 of the DGCL, subject to the 120-day statute of limitations on such claims imposed by Sections 204 and 205.

If the statutory requirements for ratification are properly followed, then under Section 204(f), the ratified act shall "no longer be deemed void or voidable as a result of a failure of authorization" and such effect shall be retroactive to the time of the original act. Similarly, share of any putative stock issued pursuant to such defective act and identified in the board's ratifying resolutions shall no longer be deemed void or voidable as a result of a failure of authorization, and shall be deemed an identical share of such stock as of the time it was purportedly issued. If any act ratified under Section 204 would have required a filing with the Delaware Secretary of State, then, whether or not such filing was made previously, the corporation must file a "certificate of validation."

Sections 204 and 205 do not take effect until April 1, 2014.

Proceedings regarding validity of defective corporate acts and stock [§ 205].— As a complement to the self-help, ratification process offered by new Section 204, Section 205 allows the Delaware Court of Chancery to determine the validity or effectiveness of any prior corporate act or transaction, whether or not ratified under Section 204. Specifically, the Court is given the power to, among other things, determine the validity or effectiveness of any prior defective corporate act or any ratification of such act, and to modify or waive any of the procedures set forth in Section 204 to ratify a defective act. An action seeking such a ruling may be brought by several different parties identified by the statute, namely, the corporation or any successor to the corporation, any director, any record or beneficial holder of valid or putative stock (at the time of such action or at the time of a defective act ratified under Section 204) or any other person claiming to be substantially and adversely affected by a ratification under Section 204.

The remedies that may be granted by the Court of Chancery under Section 205 include validating any defective corporate act or putative stock or, conversely, declaring that a ratification under Section 204 is not effective or shall only be effective at such time or upon such conditions as are established by the Court. The Court may also require measures to remedy or avoid harm to any person substantially and adversely affected by a ratification, excluding any harm that would have resulted if the defective corporate act had been valid in the first place (for example, the dilutive effect on other stockholders of a defectively-authorized stock issuance). Any action under Section 205 is subject to the 120-day statute of limitations noted above, although, importantly, the statute of limitations does not apply to an action asserting that a ratification was not accomplished in accordance with Section 204, or to any person who was entitled to receive notice under Section 204 but was not in fact given such notice.

In considering an appropriate remedy under Section 205, the Court of Chancery is specifically empowered to consider such factors as whether the defective corporate act was originally approved with the belief that such approval was proper, whether the corporation has treated the defective act as valid and whether any person has relied on the public record of such action (e.g., a charter amendment creating new stock or effecting a stock split). Presumably, factors such as "good intent" and reliance would support validation.

As noted above, Section 205, like Section 204, does not take effect until April 1, 2014.

MERGERS

Merger or consolidation [§§ 251, 252] and appraisal rights [§ 262].—Important amendments adopted in 2013 will streamline the consummation of "two step" mergers. In order to understand the purpose and effect of the amendments, it is necessary to understand the mechanics of such mergers and the market practices that have developed in recent years for consummating them.

Many mergers involving Delaware corporations are accomplished pursuant to "two step" merger agreements, which involve: (1) a negotiated tender offer to acquire at least a minimum percentage of the target company's shares (typically a majority of the outstanding), and (2) a second step merger that converts all remaining shares into the same price received in the tender offer. The second step merger generally requires a stockholder vote. Even though the requisite approval can be given by the acquiror (having become majority owner as a result of the tender), the vote itself still must be taken in accordance with applicable law – which, for public companies, often means holding a stockholders meeting preceded by notice (minimum 20 days under Delaware law), distribution of a proxy statement and SEC review. This process is expensive and delays the target stockholders' receipt of their merger consideration, notwithstanding that the vote is a foregone conclusion. It may also create problems with the acquiror's acquisition financing if the lenders will not fund payment of the tender price until the acquiror obtains 100% ownership of the target.

One way around the vote is if the acquiror obtains at least 90% of all classes of voting stock, in which case the second step merger can be accomplished without a vote under Section 253 or 267 of the DGCL, Delaware's "short form" merger statutes. The 90% ownership level could be reached in the tender offer, or by exercise of a "top-up" option granted to the acquiror by the target (typically exercisable only following the acquiror's acquisition of at least a majority of the outstanding stock, *i.e.,* the amount typically required to deliver the requisite stockholder vote if the merger had to be voted on). Such top-up options have been upheld by Delaware courts and have become commonplace in two step mergers. *In re Cogent Shareholder Litigation*, 7 A.3d 487, 505 (Del. Ch. 2010) (noting that use of top-up options is "ubiquitous in two-step acquisitions"). However, such options will not enable an acquiror to get to the necessary 90% ownership level unless the target has sufficient authorized but unissued shares available for issuance, which may not be the case given the large number of shares often needed to get to 90%. Thus, top-ups will not always work, potentially leaving acquirors and targets with the cost, delay and potential financing problems noted above.

To alleviate these problems, amendments have been made to Section 251 of the DGCL, the cornerstone section of the statute governing mergers. Specifically, Section 251 has been amended to add a new subsection (h). Subsection (h) permits any two step merger agreement entered into on or after August 1, 2013 to provide that no stockholder vote is required for the second step merger, provided that several conditions are satisfied, including:

(1) the merger agreement states that the merger is governed by Section 251(h) and will be effected as soon as practicable following the first step tender offer;

(2) the acquiror consummates a tender offer for any and all shares on the terms provided in the merger agreement and, as a result, owns at least the percentage of stock of the target that would be required to adopt the merger agreement if a vote were required;

(3) at the time that the target board adopts the merger agreement, no other party to the merger agreement is an "interested stockholder" under Section 203 of the DGCL (Delaware's anti-takeover statute, which imposes certain restrictions on 15% stockholders in certain circumstances; thus, as stated in the legislative synopsis to the statute, Section 251(h) is available only to an "arms'-length third-party acquiror"); and

(4) the acquiror merges with the target pursuant to the merger agreement and the other stockholders of target receive the same amount and kind of consideration that was paid in the tender offer.

Section 251(h) can only be used if the target corporation is public (*i.e.,* shares listed on a national securities exchange or held of record by more than 2,000 holders) and if the acquiror is a corporation (as opposed to an "alternative entity" such as a limited liability company or limited partnership; it is possible that future amendments will be adopted to allow Section 251(h) to be used by alternative entity acquirors, just as such entities are permitted to effectuate short form mergers with corporations under Section 267 of the DGCL).

In connection with the adoption of Section 251(h), conforming changes are being made to Section 252 (governing mergers between Delaware and non-Delaware corporations) and Section 262, the appraisal statute. Importantly, a copy of the appraisal statute must be provided to stockholders in connection with most mergers; therefore, on and after August 1, 2013, practitioners should take care to use the amended statute. Practitioners should also note that Section 251(h) does not affect director fiduciary duties. As stated in the legislative synopsis, Section 251(h) "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 merger agreement, each of which will be determined based on the common law of fiduciary duty, including the duty of loyalty."

APPRAISAL; SHELF CORPORATIONS; FRANCHISE TAXES

Appraisal rights [§ 262(b) and (d)].—Sections 262(b) and (d) have been amended to provide for appraisal rights in connection with mergers authorized pursuant to Section 251(h). In particular, Section 262(d) has been amended to provide that, in the case of a merger authorized pursuant to Section 251(h), stockholders entitled to appraisal rights must demand appraisal within the later of: (i) 20 days after the date of the corporation's mailing of notice or (ii) the consummation of the tender or exchange offer. Section 262(d) has also been amended to provide for subsequent notice of the effective time of the merger in the case of a merger approved pursuant to Section 251(h). The amendments to Sections 262(b) and (d) are effective only with respect to merger agreements adopted (or board resolutions approved, in the case of mergers pursuant to Section 253) after August 1, 2013, and appraisal proceedings arising out of such transactions.

Amendments to deter use of "shelf" corporations [§ 312(b); § 502(a)].—Sections 312(b) and 502(a) were amended to discourage the creation of "shelf" corporations that are not intended to be used in the foreseeable future but, rather, are created by an incorporator to hold for later use with no current activity and no current directors or stockholders. Section 312(b) was amended to clarify that a corporation may renew or revive its certificate of incorporation only by complying with Section 312, which requires that a renewal or revival of a certificate of incorporation must be approved by the corporation's directors (and, thus, cannot be approved by an incorporator). Section 502(a) was amended to limit the incorporator's ability to sign an annual report other than the initial annual report and to require that all annual franchise tax reports must list a director, subject to certain limited exceptions. The amendment is intended to prohibit an incorporator from filing an annual report or listing no directors in an annual report.

Certificate of validation: effect on taxes [§ 503(e)].—Section 503(e) has been amended to clarify that the filing of a certificate of validation pursuant to Section 204 will not reduce the amount of franchise taxes due for any period prior to the filing of such certificate of validation. In addition, if the certificate of validation would cause any additional franchise tax to be due for any period prior to the filing of the certificate, then such amounts will be calculated at the current rates. This amendment becomes effective on April 1, 2014.

PUBLIC BENEFIT CORPORATIONS

Public benefit corporations [DGCL Subchapter XV, §§ 361-368].—A new Subchapter XV has been added to the DGCL to permit the formation of "public benefit corporations." A public benefit corporation (or "PBC") is a for-profit corporation which is managed not only for the pecuniary interests of its stockholders but also for the benefit of other persons, entities, communities or interests. This is an important innovation in Delaware law because, while directors generally may take into account the interests of various stakeholders and constituencies in managing the corporation, current law suggests that the ultimate beneficiaries of director fiduciary duties must be the corporation's stockholders. Directors of a PBC, however, will have an express statutory obligation to balance stockholder interests with other interests. The goal of the legislation is to enable a for-profit entity also to focus on creating societal benefit, notwithstanding some cost to generating financial value for stockholders. Although several other states have benefit corporation statutes, the new Delaware statute includes important differences, including that a specific public benefit purpose must be identified in the Delaware corporation's certificate of incorporation. The legislation offers an alternative form of business structure for entrepreneurs and investors who wish to do business through a corporate entity that may sacrifice some profit in order to benefit other interests such as communities, employees and the environment.

Section 362 of the DGCL defines a public benefit corporation as a "for-profit corporation organized under and subject to the requirements of this chapter [the DGCL] that is intended to produce a public benefit or public benefits and to operate in a responsible and sustainable manner." Every public benefit corporation must identify itself by including those words, or "P.B.C." or "PBC."

Two key requirements of the statute are the purpose requirement and the balancing requirement. A public benefit corporation must set forth, within its certificate of incorporation, a purpose of promoting "one or more specific public benefits," which benefits must be specifically identified. "Public benefits" are broadly defined to include positive effects (or reduction of negative effects) on persons, entities, communities or interests of an artistic, charitable, cultural, economic, educational, environmental, literary, medical, religious, scientific or technological nature.

The balancing requirement of the statute provides that a public benefit corporation must be managed in a manner that "balances the stockholders' pecuniary interests, the best interests of those materially affected by the corporation's conduct, and the public benefit or public benefits identified in its certificate of incorporation." Section 365 makes clear that it is the responsibility of the board of directors to make these balancing decisions. However, the statute also provides that in doing so, directors do not owe duties to any non-stockholders. Furthermore, directors will receive the benefit of the business judgment standard of review if stockholders challenge a disinterested balancing decision. Only stockholders owning a material stake in the corporation (generally at least 2% or, in the case of public corporations, the lesser of 2% or $2 million in market value) are permitted to bring derivative suits to enforce the balancing requirement.

The statute also imposes specific reporting requirements on PBCs. At least every two years, the corporation must provide a report to its stockholders discussing the corporation's promotion of its chosen public benefits and the best interests of those materially affected by its conduct. The statute contains specific criteria for the board to address in the report. The statute also permits the certificate of incorporation of a PBC to require more frequent reports or the use of a third party standard, or a third party certification process, for measuring the corporation's commitment to and success in promoting its public goals. Unlike some other states, Delaware does not require a third party certification (unless so provided in the certificate of incorporation).

In addition to the formation of new corporations as public benefit corporations, existing corporations can adopt PBC status by charter amendment or merger, but only with the approval of 90% of the outstanding shares of each class of the corporation's stock. Stockholders who do not vote in favor of the change are entitled to appraisal rights under Section 262 (which was amended to reflect the PBC statute, as well as the new section of the merger statute, Section 251(h)). A PBC cannot eliminate or change the public benefit corporation provision in its charter without the approval of two-thirds of the outstanding shares of each class of stock.

Although it is too soon to gauge the market reaction to the PBC model, by providing an alternative structure for profit-making enterprises, the PBC offers entrepreneurs and investors a hybrid that requires consideration of both stockholder and non-stockholder interests, permits directors to advance the latter even when doing so may compromise economic value for stockholders, and requires a high level of transparency concerning the achievement of the corporation's public purpose goals through statutory reporting requirements.

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