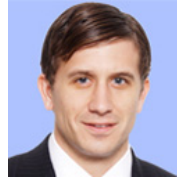


The Equitable Case for Ratification

By John Mark Zeberkiewicz and Stephanie Norman

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John Mark Zeberkiewicz



Stephanie M. Norman

Among the many significant proposed changes to Delaware's General Corporation Law that were submitted to the corporation law section of the Delaware State Bar Association this March for approval, the sections dealing with ratification of defective corporate acts stand out as particularly noteworthy. Although the proposed sections, which would become effective in April 2014 if enacted, are somewhat procedurally complex, the general idea of the proposed sections is that defective corporate acts may be subsequently validated through board (and, in some cases, stockholder) approval. The new sections would not provide the exclusive means of ratifying defective corporate acts, and acts that are susceptible to cure under the existing common law of ratification may still be effectively ratified through such means, regardless of compliance with the new ratification sections. While a properly ratified act would be given retroactive legal effect and would therefore be insulated from challenge on the grounds of the original defect in authorization after a specified period, it would not be immune from equitable attacks. Accordingly, despite ratification, these acts would remain subject to the "twice tested" rule mentioned in the Delaware Chancery Court's recent opinion in *Carsanaro v. Bloodhound Technologies*, -- A.3d --, C.A. No. 7301-VCL, (Del. Ch. Mar. 15, 2013).

If enacted, the new ratification sections would overturn the harsh precedent from the Delaware Supreme Court's opinion in *STAAR Surgical v. Waggoner*, 588 A.2d 1130 (Del. 1991), and applied in cases like *Liebermann v. Frangiosa*, 844 A.2d 992 (Del. Ch. 2002), and *Blades v. Wisheart*, C.A. No. 5317-VCS, (Del. Ch. Nov. 17, 2010), that stock not issued in strict compliance with statutory formalities may be found void or voidable. Without a statutory basis to hold otherwise, the Delaware courts have "refused to overlook the statutory invalidity of stock even in situations when that might generate an inequitable result," as the court held in *Liebermann*, and have declined to "ignore the statutory infirmity" in stock issuances simply because their "equitable heartstrings have been plucked," as the court held in *Blades*.

The underlying rationale for the principle in these cases is that certainty in a corporation's capital structure is so fundamentally important that it must be fixed with the type of clarity that can only come through strict conformity with the statutory procedures that transform offers, promises and payments into personal property imbued with specified characteristics. While not without some appeal, the consequences of this line of reasoning have, perversely, introduced uncertainty into capital structures that appeared otherwise sound. In at least one opinion post-*STAAR*, the Chancery Court recognized this reality and permitted ratification of a defective stock issuance — in *Kalageorgi v. Victor Kamkin*, 750 A.2d 531 (Del. Ch. 1999). Despite reciting (albeit without express citation) *STAAR*'s basis for adhering to formalism, the *Kalageorgi* court was apparently troubled with the situation before it, which it described as a "counterexample" of the typical scenario where "the imperatives of law and the demands of equity pull in the same direction." The court stated that invalidating stock for "purely formalistic reasons would defeat not only the board's clear intent but also the purpose of the formal requirements themselves, which is to create indisputable evidence that the board intended to authorize the issuance of the securities."

Despite this tension in following form over equity, particularly in situations involving the validity of a stock issuance, *STAAR* remains controlling precedent, and its restrictions on remediating defective corporate acts often leave corporations and their counsel in a bind — frequently at an inopportune time, as in the periods leading up to an initial public offering or a significant new private placement, when counsel is charged with providing a valid issuance opinion and begins culling through years' worth of corporate records (or, worse yet, discovers that there are no records to cull through). Where serious problems or gaps are uncovered, the potential fixes are often either impracticable or, even if possible, costly and undesirable for other reasons, like tax or accounting. The new ratification sections would provide corporations (and their counsel) a practical means to address these problems, in ways that would give effect to the corporations' and its investors' intent and would enable counsel to confidently opine on the validity of the stock.

What the new sections would not do is circumscribe the court's power to invalidate stock or other corporate acts, whether or not validated under the new sections, on equitable grounds. Although not raised in the context of ratification, the Chancery Court's recent opinion in *Bloodhound* provides some insight into how

the Delaware courts would likely treat equitable challenges to defective corporate acts ratified in accordance with the new sections (assuming their enactment). The *Bloodhound* court addressed alleged statutory defects in an amendment to the corporation's certificate of incorporation. While the court, ruling on a motion to dismiss, found that the complaint stated a claim with respect to certain aspects of the amendment, it found that an amendment resetting the economics of certain series of preferred stock was not statutorily invalid. Nevertheless, the statutory validity of the amendment did not end the analysis. As the court stated, "Corporate acts are 'twice-tested,' once for statutory compliance and again in equity." Thus, for example, a Delaware court would not be precluded from granting equitable relief for a stock issuance or other act, even if ratified under the new sections, on fiduciary duty grounds. The ratified act would be treated as any other "twice-tested" act that satisfies the technical, but not the equitable, part of the test, as was the case in *Johnston v. Pedersen*, 28 A.3d 1079 (Del. Ch. 2011), where the court declined to enforce a vote of the preferred stockholder's super-voting stock where the directors, despite issuing such super-voting preferred stock in compliance with statutory requirements, were found to have violated their fiduciary duties by issuing the stock to defeat an insurgent slate in a proxy contest.

Simply put, the new ratification sections, if enacted, would help to minimize the circumstances in which equity and law pull in different directions, freeing the Delaware courts to decide cases with greater regard to the underlying equities and the parties' understandings and original intentions.

John Mark Zeberkiewicz is a director, and **Stephanie Norman** is an associate, of Richards, Layton & Finger. They focus on transactional matters involving Delaware corporations, including mergers and acquisitions, corporate governance and corporate finance. The views expressed in this article are those of the authors and not necessarily those of the firm or its clients.

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