INSIGHTS

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CORPORATE GOVERNANCE

Significant Proposed Amendments to the General Corporation Law of the State of Delaware

The 2013 proposed amendments to the DGCL include some of the most substantial and ground-breaking developments in statutory law in Delaware in years. The proposed legislation would eliminate the back-end vote in certain two-step takeovers, thereby reducing the delay (and associated costs) of holding a meeting to obtain such vote. In addition, the proposed legislation would enable corporations to validate defective corporate acts, including stock and option issuances that might otherwise be invalid. The proposed legislation also would introduce a new "benefit corporation" statute, which would enable corporations to be managed not only for the purpose of maximizing wealth for their stockholders, but also to further identified social benefits.

By William J. Haubert, John Mark Zeberkiewicz, and Brigitte V. Fresco

Legislation proposing to amend the General Corporation Law of the State of Delaware (DGCL) and related sections of title 8 of the Delaware Code has been introduced in the General Assembly of the State of Delaware.[1] The proposed legislation, if enacted, would make significant changes to the DGCL, with potentially wide-ranging effects on the M&A and corporate finance practices.

- ***Elimination of Required Vote in Certain Second-Step Mergers.*** Subject to certain conditions, the proposed legislation would eliminate the need for a stockholder vote on the back-end merger that follows a public tender or exchange offer in which the acquirer has secured the number of shares that would have been necessary to approve the merger. In recent years, parties seeking to eliminate the vote on the back-end merger could often do so only through a "top-up" option, which was less than ideal, since it frequently required the acquirer to secure a supermajority of the outstanding shares in the tender and was only available in cases where the target had a substantial number of authorized and unissued shares. The new legislation, which would apply generally to public corporations, would be available regardless of the target's pre-merger capital structure.
- ***Ratification of Defective Corporate Acts.*** The proposed legislation would add two new sections to the DGCL, Sections 204 and 205,

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which together would provide corporations methods to validate their stock and other corporate acts (the Ratification Amendments). Section 204 sets forth a "self-help" ratification procedure, and Section 205 sets forth a procedure in which parties may seek relief from the Court of Chancery of the State of Delaware (the Court of Chancery). The new legislation would reverse the case law holding that certain defective corporate acts are "void" and thus cannot be ratified. As a result of the new legislation, corporations can take measures to eliminate the uncertainty in their capital structure. The Ratification Amendments will help to give corporations greater confidence in their capital structures—and will help their advisors to confidently render valid issuance opinions.

- ***Formula for Stock Issuance Consideration.*** The proposed legislation includes an amendment to Section 152 of the DGCL that would confirm the board's authority to establish a formula for determining the consideration the corporation receives for the issuance of capital stock. This amendment would clarify that a board may authorize the issuance of stock for consideration derived by reference to a formula, such as the market price of the stock measured over a period of time.
- ***Public Benefit Corporations.*** The proposed legislation would add a new subchapter of the DGCL governing "public benefit corporations," which are defined generally as for-profit corporations organized to produce certain "public benefits" (*e.g.*, charitable, artistic, social, or educational goals) and to operate in a responsible and sustainable manner. Unlike the directors of general for-profit corporations, the directors of public benefit corporations, in discharging their fiduciary duties, would not be required to focus exclusively on maximizing wealth for the benefit of stockholders, but would be entitled to consider other interests related to the corporation's public benefit purpose.
- ***Restrictions on "Shelf" Corporations.*** The proposed legislation would enact amendments intended to deter the establishment of "shelf" corporations—that is, corporations that are formed without directors or stockholders and with the purpose of "aging" the corporation for use many years in the future.

If the proposed legislation is enacted, the amendments, other than the Ratification Amendments, would become effective on August 1, 2013. The Ratification Amendments, if enacted, would not become effective until April 1, 2014, in order to provide the Delaware Secretary of State sufficient time to modify its system to permit the filing of the certificate of validation discussed in more detail below.

Elimination of Required Vote in Certain Second-Step Mergers

The proposed legislation would amend Section 251 to add a new subsection (h), which (absent a provision in a corporation's certificate of incorporation to the contrary) would eliminate the requirement for a stockholder vote to authorize a second-step merger that follows a public tender offer, subject to certain requirements. Currently, in a typical two-step merger, the acquirer commences a tender offer and, if a sufficient number of shares are tendered, consummates a back-end merger to cash out the shares not tendered in the offer. Even though the back-end vote is a *fait accompli*, the takeover cannot be completed without it under the current statute (absent acquiring enough shares to effect a short-form merger). Where the target corporation's charter prohibits action by written consent—as is often the case with public companies—acquirers seeking to complete the back-end merger are often forced to call and hold a meeting of stockholders. That involves a minimum 20-day notice period (although the actual time period is frequently much longer) and gives rise to other mailing and printing expenses—not to mention the complications with financing.

To date, the only effective means of avoiding the expense and delay of holding the back-end merger vote has been to secure a so-called top-up option (again, absent acquiring enough shares to effect a short-form merger), which provided that, if the acquirer received a certain number of shares of stock in the front-end tender, the target corporation would issue to the acquirer that number of additional shares to enable it to own 90 percent of each class of voting stock and to consummate a short-form merger under either Section 253 or Section 267 of the DGCL. While the top-up structure has been recognized as valid by the Delaware courts,[2] and it has in recent years become a common feature in the M&A landscape, it is not available in every situation. That is, whether a top-up option is available depends upon the number of authorized and unissued shares of the target corporation. Since the number of shares needed to increase the acquirer's stake by even a single percentage point is often massive, the top-up option, even if available, is frequently limited, since the acquirer must first obtain a supermajority of the shares (and often in the range of 80 to 85 percent) before it can exercise the top-up option.

The target board would retain the negotiating leverage it currently has regarding top-up options.

The new subsection would allow transactional parties to dispense with the need for the top-up option and to proceed with the back-end merger, without the need for a vote, after the acquirer has secured the requisite percentage of shares in the tender that would be required to approve the merger (typically, a majority of the outstanding voting stock). The new subsection would apply only to target corporations whose shares are listed on a national securities exchange or held of record by more than 2,000 holders immediately prior to the execution of the merger agreement.

If new subsection (h) applies to the target corporation, a vote of the target corporation's stockholders would not be required to authorize the merger if: (1) the merger agreement expressly provides that the merger shall be governed by this new subsection and shall be effected as soon as practicable following the consummation of the offer described below; (2) a corporation consummates a tender or exchange offer for any and all of the outstanding stock of the target corporation on the terms provided in such merger agreement that would otherwise be entitled to vote on the adoption of the merger agreement; (3) following the consummation of the offer, the consummating corporation owns at least the percentage of the stock of the target corporation that otherwise would be required to adopt the merger agreement; (4) at the time the target corporation's board of directors approves the merger agreement, no other party to the merger agreement is an "interested stockholder" (as defined in Section 203(c) of the DGCL) of the target corporation; (5) the corporation consummating the offer merges with the target corporation pursuant to such merger agreement; and (6) the outstanding shares of the target corporation not canceled in the merger are converted in the merger into the same amount and kind of consideration paid for shares in the offer.

The proposed legislation would also amend Section 252 of the DGCL to reflect the usage of subsection 251(h) in the context of a Delaware corporation merging with a non-Delaware corporation. The proposed legislation would make additional changes to Section 262 of the DGCL to provide that appraisal rights would be available for a merger effected pursuant to subsection 251(h), unless all of the stock of the target corporation is owned by the offering corporation immediately prior to the merger.

New subsection 251(h) would not change the fiduciary duties of directors in connection with such mergers or the level of judicial scrutiny that would apply to the decision to enter into such a merger agreement, each of which would be determined based on the common law of fiduciary duty, including the duty of loyalty. Since subsection 251(h) would apply only if provided for in the merger agreement, the target board would retain the negotiating leverage it currently has regarding top-up options.

Ratification of Defective Corporate Acts

The Ratification Amendments represent an important development in corporate law. New Section 204 of the DGCL would enable corporations to use "self-help" mechanisms to remedy actions that, due to a failure in the original authorization, could be challenged as void or voidable under existing case law. Where the defect is such that the self-help procedure is not available or practical, new Section 205 would provide that certain interested parties may petition the Court of Chancery to validate or invalidate, as the case may be, the defective act.

The Ratification Amendments were designed to overturn the rigid holdings in cases such as *STAAR Surgical Co. v. Waggoner*[3] that have held that stock issued in violation of statutory or charter-based requirements is void and cannot be cured or ratified. This precedent has led the Court of Chancery, in cases such as *Blades v. Wisehart*,[4] to invalidate certain defective corporate acts, even if such invalidation is inequitable. As a result of the new legislation, corporations can take measures to eliminate the uncertainty in their capital structure that might result through the application of such case law. The Ratification Amendments would help to give corporations greater confidence in their capital structures—and will help their advisors to confidently render valid issuance opinions.

Under the Ratification Amendments, no "defective corporate act" (*i.e.*, the act to be ratified) would be void or voidable solely on the basis of a "failure of authorization" (generally, a failure to comply with the certificate of incorporation, the bylaws, the DGCL or any plan or agreement), so long as the act is ratified in accordance with the procedures outlined in new Section 204 or validated by the Court of Chancery in a proceeding under new Section 205.[5] The Ratification Amendments would thus give corporations (as well as the Court of Chancery, upon application by specified parties) a path to avoid inequitable outcomes that might otherwise result from a defective corporate act not being susceptible to cure.

Section 204: The Self-Help Procedure

New Section 204 would enable the board of directors to take steps, without the need to seek assistance from the Court of Chancery, to validate defective corporate acts. Implicit in the board's power to take such self-help measures, though, is the existence of a valid board. In cases where, due to defects in the corporate structure or for other reasons, a valid board is not in place, parties would need to take action under new Section 205 or existing Section 225 for relief. While new Section 204 is intended to mitigate the harsh outcomes that might otherwise result from noncompliance with statutory or other corporate requirements, it would not be a carte blanche for boards of directors to avoid those requirements.

New Section 204 would enable the board of directors to take steps to validate defective corporate acts.

The defective corporate act would have to be approved by board resolution. That resolution would have to contain certain information regarding the defective corporate act to be ratified, including a summary of the act, the time at which the act was taken and the nature of the defect in its authorization. This would include, in the case of a defective corporate act relating to the issuance of shares, the number of shares purportedly issued, the date they were purportedly issued, the class or series of such shares and the problem with the issuance.

New Section 204 would include provisions that establish the quorum and voting requirements applicable to any board vote required to adopt a ratifying resolution. Those requirements would be based on the quorum and vote applicable at the time of adoption for the type of defective corporate act proposed to be ratified. If the certificate of incorporation or bylaws of the corporation, any plan or agreement to which the corporation was a party or any provision of the DGCL at the time of the defective corporate act would have required a larger number or portion of directors or of specified directors for a quorum to be present or to approve the defective corporate act, the presence or approval of such larger number or portion of such directors or of such specified directors would be required. New Section 204, however, would recognize that, in cases where directors elected by specified class(es) or series of stock are no longer in office because such class(es) or series are no longer outstanding, the vote of such directors would not be required.

In cases where the defective corporate act would have required stockholder approval (*e.g.*, an amendment to the certificate of incorporation or a merger), the board of directors would be required to submit the ratifying resolution to a vote of stockholders. To ensure that the Ratification Amendments would not be used as a means of circumventing Section 203, the DGCL's principal anti-takeover statute, new Section 204 would require any defective corporate act resulting from a failure to comply with Section 203 to be submitted to stockholders for ratification, regardless of whether a stockholder vote would have been required at the time of the defective corporate act.

New Section 204 would contain detailed provisions for providing notice to, and seeking a vote of, stockholders in cases where a stockholder vote would be required. In these cases, the corporation would need to provide notice to all current holders of the corporation's valid stock and "putative stock" (generally, stock that, but for a defect in authorization, would be valid) as well as to holders of valid stock and putative stock as of the time of the defective corporate act, in each case, whether such shares are voting or nonvoting shares. In the latter case, new Section 204 would provide that the notice need not be provided if the holders at such earlier date cannot be determined from the corporation's records. New Section 204 would require that the notice contain a copy of the ratifying resolution as well as a statement regarding the 120-day limitations period, imposed by new Section 204 on challenges to acts ratified under new Section 204 or validated under new Section 205.

New Section 204 would then provide for the quorum and stockholder vote necessary to adopt the ratifying resolutions. As a general matter, the quorum and vote required at the time the ratifying resolution is submitted to the stockholders would be sufficient to adopt the resolution, unless the DGCL, the certificate of incorporation or bylaws, or another plan or agreement in effect at the time of the defective corporate act would have required a greater vote. As with the quorum and vote required for the board's vote, the stockholder quorum and vote provisions would make exceptions, in the latter case, for shares of any class(es) or series that are no longer outstanding. In the case of an election of directors, ratification would require the affirmative vote of the majority of shares present at the meeting and entitled to vote on the election of the director (or such greater vote that would have been required under the certificate of incorporation or bylaws at the time of the election). Thus, a "plurality" of the votes would not be sufficient to ratify an election. In addition, ratification of a failure to comply with Section 203 would require the vote required under Section 203(a)(3)—generally, 66 2/3 percent of the voting stock owned by holders other than the "interested stockholder."

New Section 204 would provide that, if the defective act being ratified would have required a filing with the Delaware Secretary of State (*e.g.*, a certificate of amendment, certificate of designation, certificate of merger, or other instrument), the corporation is required to file a new instrument called a "certificate of validation." The certificate of validation must set forth (1) a copy of the ratifying resolution, (2) the date of its adoption by the board of directors and, if applicable, the stockholders, (3) the information that would have been specified in the filing that would otherwise be required, and (4) if a certificate was previously filed with respect to the defective corporate act being ratified, the title and the date of the filing of such previously filed certificate and any certificate of correction thereto.

New Section 204 would give effect to existing case law that the ratification of a prior act relates back to the time of the original act.[6] Thus, under new Section 204, unless otherwise determined by the Court of Chancery in an action pursuant to new Section 205, each defective corporate act (or each share purportedly issued) that is ratified pursuant to new Section 204 would be retroactively valid as of the time of the defective corporate act. Thus, for purposes of the DGCL, shares that were intended to be issued at a certain date, or options that were intended to be granted at a certain date, would be valid as of those dates if properly ratified in accordance with new Section 204.

To further ensure that new Section 204 would not operate to prejudice the rights of any party in interest, it would require that notice of the ratifying resolution be provided even where no stockholder approval is necessary. This notice would need to be provided to all current stockholders as well as to holders of valid and putative stock as of the time of the defective corporate act to be ratified (unless those holders cannot be identified from the corporation's records). This notice would need to contain substantially the same notice provided to stockholders in the case where a vote of stockholders is required.

Section 205: Application to the Court of Chancery

The corollary to new Section 204 is new Section 205. New Section 205 would confer jurisdiction on the Court of Chancery to hear and determine the validity of any ratification effected pursuant to new Section 204 and the validity of any corporate act or transaction and any stock or rights or options to acquire stock, and to modify or waive any of the procedures set forth in new Section 204. New Section 205 also would give corporations (upon application by specified interested parties) the ability to seek a determination of the validity of acts that are not susceptible to cure under new Section 204—as would be the case where, for example, no valid board is in place to adopt the ratifying resolution. Finally, it would provide various parties the right to challenge the validity of ratifications under new Section 204 as well as the right to challenge defective corporate acts.

General: Legal and Equitable Challenges

Where a party is challenging a defective act ratified in accordance with new Section 204, it would be required to do so within the 120-day limitations period provided for in the proposed legislation, subject to certain exceptions. After that date, the act would not be invalidated. While the Ratification Amendments would provide corporations with substantial authority to seek ratification of defective corporate acts, they would not affect the fiduciary duties applicable to any particular decision—either the initial decision by the board to approve the defective corporate act or the later decision by the board to seek ratification of the act.[7] Given that the Ratification Amendments were designed to give corporations an opportunity to cure defective corporate acts that, under existing law, would be void and not susceptible to cure under the common law of ratification, they recognize that the new provisions are not intended to preempt or restrict other means of ratifying acts that are merely voidable.[8]

Formula for Stock Issuance Consideration

The proposed legislation would add language to Section 152 of the DGCL, which addresses the authorization and issuance of capital stock, to clarify that a board of directors may determine the price or prices at which the corporation's stock is issued by approving a formula by which such price or prices is determined.[9] This would enable, among other things, stock to be issued for consideration derived by reference to, for example, the market price of the stock measured over a period of time.

Public Benefit Corporations

In a development that may be of significant interest to social entrepreneurs and others seeking to promote social welfare in a for-profit setting, the proposed legislation would add a new subchapter XV to the DGCL (Sections 361 through 368) to enable Delaware corporations to be incorporated as or, subject to certain restrictions, to become "public benefit corporations." Such corporations would remain subject to all other applicable provisions of the DGCL, except as modified or supplanted by the new subchapter.

> ***The new subchapter would impose special notice requirements on public benefit corporations.***

In general, under the proposed legislation, a public benefit corporation would be a corporation managed in a manner that balances the stockholders' pecuniary interests, the interests of those materially affected by the corporation's conduct, and one or more public benefits identified in its certificate of incorporation. To this last point, each public benefit corporation would be required, in its certificate of incorporation, to identify itself as a public benefit corporation and to state the public benefits it intends to promote. The proposed legislation generally defines "public benefits" as positive effects (or minimization of negative effects) on persons, entities, communities or interests, including those of an artistic, charitable, cultural, economic, educational, literary, medical, religious, scientific, or technological nature.

Central to the proposed new subchapter's operation is the statutory mandate that would be imposed on directors. The new subchapter would provide that directors, in managing the business and affairs of the public benefit corporation, shall balance the pecuniary interests of the stockholders, the interests of those materially affected by the corporation's conduct, and the identified public benefits. The new subchapter also would provide that directors shall not have any duty to any person solely on account of any interest in the public benefit and would provide that, where directors perform the balancing of interests described above, they will be deemed to have satisfied their fiduciary duties to stockholders and the corporation if their decision is both informed and disinterested and not such that no person of ordinary, sound judgment would approve.

The new subchapter would impose special notice requirements on public benefit corporations, mandating periodic statements to stockholders regarding the corporation's promotion and attainment of its public benefits. The new subchapter also would provide a means of enforcing the promotion of the public benefits. By statute, stockholders holding at least 2 percent of the corporation's outstanding shares (or, in the case of listed companies, the lesser of 2 percent of the outstanding shares or shares having at least $2 million in market value) would be able to maintain a derivative lawsuit to enforce specified requirements in the subchapter.

The new subchapter would contain limitations on the power of public benefit corporations to adopt amendments to their certificates of incorporation or effect mergers or consolidations if the effect would be to abandon their public benefit purpose. These limitations would be imposed through a 66 2/3 percent vote of each class of the public benefit corporation's outstanding stock.

The new subchapter also would contain limitations on the power of corporations that are not public benefit corporations to amend their certificates of incorporation to become public benefit corporations or to effect mergers or consolidations that would result in their stockholders receiving shares in a public benefit corporation. These actions would require a 90 percent vote of each class of the corporation's outstanding stock. New subchapter XV would also provide appraisal rights to any stockholder of a corporation that is not a public benefit corporation that, by virtue of an amendment to the corporation's certificate of incorporation or any merger or consolidation, receives equity interests in a public benefit corporation. Corresponding changes to Section 262 of the DGCL, the appraisal section, also would be made.

Restrictions on "Shelf" Corporations

The proposed legislation also includes amendments to Section 312(b) of the DGCL and Section 502(a) of title 8 of the Delaware Code that are intended to deter the practice of forming "shelf" corporations—that is, corporations with no stockholders or directors that are "aged" for use many years in the future. The proposed amendments would accomplish this goal by confirming the limited powers of an incorporator. The proposed amendments would clarify that only a corporation's directors or stockholders may authorize a renewal or revival of a corporation that has ceased to be in good standing. They would also prohibit an incorporator from signing any annual franchise tax report other than the corporation's initial report. In addition, the amendments would prohibit such later reports from listing "no directors," except in the case of a report filed in connection with the corporation's dissolution.

Notes

1. H.B. 127, 147th Gen. Assem. (Del. 2013) (containing the amendments to the DGCL relating to, *inter alia*, (i) the elimination of the required vote in certain two-step mergers, (ii) the ratification of defective corporate acts, (iii) the formula for stock consideration, and (iv) the restrictions on "shelf corporations"); S.B. 47, 147th Gen. Assem. (Del. 2013) (containing the amendments to the DGCL relating to public benefit corporations). AS OF June 10, 2013, House Bill No. 127 has been approved by the Delaware House of Representatives and has been submitted to the Delaware Senate Judiciary Committee, and Senate Bill No. 47 has been approved by the Delaware Senate and has been introduced to the Delaware House of Representatives.

2. *Olson v. ev3, Inc.*, C.A. No. 5583-VCL (Del. Ch. Feb. 21, 2011).

3. 588 A.2d 1130 (Del. 1991).

4. 2010 WL 4638603 (Del. Ch. Nov. 17, 2010), *aff'd sub nom. Wetzel v. Blades*, 35 A.3d 420 (Del. 2011) (TABLE).

5. The term "defective corporate act" is intended to include all types of corporate acts and transactions, including elections or appointments of directors, that were within the power of the corporation under the DGCL. For example, a defective corporate act would include a new issuance of a series of preferred stock that was effected without the requisite vote of the board or the holders of one or more existing series of preferred stock. The term "defective corporate act" would also include an "overissue" of stock and other defects in stock issuances that could cause stock to be treated as void or voidable. New Section 204 thus would provide a means of cure, as contemplated by Section 8-210 of the Delaware Uniform Commercial Code, for stock issued in excess of the number of shares the corporation is authorized to issue. New Section 204 also would provide a means to give effect to the provisions of Section 8-202(b) of the Delaware Uniform Commercial Code, which provides 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. New Section 204 also would provide a means of determining which shares constitute the "overissued" shares in various circumstances.

6. *See, e.g.*, *Michelson v. Duncan*, 407 A.2d 211, at 219 (Del. 1979) ("It is the law of Delaware, and general corporate law, that a validly accomplished shareholder ratification relates back to cure otherwise unauthorized acts of officers and directors."); *Schreiber v. Bryan*, 396 A.2d 512 (Del. Ch. 1978); *Hannigan v. Italo Petroleum Corp. of Am.*, 47 A.2d 169, at 173 (Del. 1945) (citing 3 THOMPSON ON CORPORATIONS 3d Ed., Section 2106, for the proposition that "'[t]he effect of a subsequent ratification is that it relates back and gives validity to the unauthorized act or contract, as of the date when it was made and affirms it in all respects as though it had been originally authorized. The act is legalized from its inception.'").

7. *See* John Mark Zeberkiewicz and Stephanie Norman, "The Equitable Case for Ratification," *Delaware Business Court Insider*, March 27, 2013.

8. In *Klig v. Deloitte LLP*, 36 A.3d 785 (Del. Ch. 2011), for example, the Court gave legal effect to a decision by members of management

of a limited liability partnership to place a partner on leave of absence, which decision was alleged to have been taken in excess of such members' authority, because their actions were subsequently properly ratified by the partnership's board of directors. In reaching this conclusion, the *Klig* Court followed the reasoning in *Lewis v. Vogelstein*, 699 A.2d 327, at 334-35 (Del. Ch. 1997), where the Court stated: "One way of conceptualizing th[e] effect [of ratification] is that it provides, after the fact, the grant of authority that may have been wanting at the time of the agent's act. Another might be to view the ratification as consent or as an estoppel by the principal to deny a lack of authority. In either event the effect of informed ratification is to validate or affirm the act of the agent as the act of the principal."

9. The proposed amendment would clarify an issue discussed, in *dicta*, in *Olson v. EV3, Inc.*, 2011 WL 704409 (Del. Ch. Feb. 21, 2011).