THE REVIEW OF
SECURITIES & COMMODITIES REGULATION
AN ANALYSIS OF CURRENT LAWS AND REGULATIONS AFFECTING THE SECURITIES AND FUTURES INDUSTRIES

Vol. 44 No. 15 September 7, 2011

VALID ISSUANCE OF CAPITAL STOCK

In two recent cases, the Delaware Court of Chancery has affirmed the importance of proper action by directors in setting the terms upon which capital stock may be issued. Corporate formalities must be carefully followed, and while directors have broad authority to set the consideration for the issuance of capital stock, they may not delegate that authority to corporate officers.

By John Mark Zeberkiewicz and Tiffany N. Piland *

In recent months, the Delaware Court of Chancery has issued two opinions, *Olson v. ev3, Inc.*[1] and *Blades v. Wisehart,*[2] dealing with the validity of capital stock. While each arose in a unique factual setting, the principles the court articulated may be relevant to corporations considering stock issuances, particularly those outside of the traditional underwritten offering context, such as at-the-market offerings and other equity programs. Since these programs typically contemplate a series of individual decisions, made over a fixed horizon, regarding the issuance of a number of shares at prices based on prevailing market rates, in each case within pre-established parameters, it would be nearly impossible to run such programs effectively if the full board of directors were required to meet to authorize each issuance.[3] For that reason, boards of directors, when establishing such programs, frequently delegate the authority necessary to implement the programs.

But unless it is structured properly, the board's delegation of the authority to issue capital stock may conflict with Delaware law – which in turn may result in questions over the validity of the stock issued pursuant

[1] 2011 WL 704409 (Del. Ch. Feb. 21, 2011).

[2] 2010 WL 4638603 (Del. Ch. Nov. 17, 2010).

[3] At-the-market offerings, for example, "enable issuers to offer and sell their equity securities through one or more registered broker-dealers in a series of public, registered transactions effected over an extended period of time and at then-prevailing market prices. . . . The issuer enters into a sales agency agreement with a broker-dealer, pursuant to which the firm agrees to sell shares on behalf of the issuer from time to time, as instructed, subject to a specified maximum number of shares and/or maximum offering price." Barbara J. Endres & Kersti Hanson, *At-the-Market Offerings – Implications of Regulation M*, 43 Rev. Sec. & Comm. Reg.1 (2010).

* *JOHN MARK ZEBERKIEWICZ is a director, and Tiffany N. Piland is an associate, at Richards, Layton & Finger, P.A. in Wilmington, Delaware. Their e-mail addresses are zeber@rlf.com and piland@rlf.com, respectively. Richards, Layton & Finger may have been involved in some of the cases discussed herein, but the opinions expressed in this article are those of the authors and not necessarily those of Richards, Layton & Finger or its clients.*

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RSCR Publications LLC Published 22 times a year by RSCR Publications LLC. Executive and Editorial Offices, 2628 Broadway, Suite 29A, New York, NY 10025-5055. Subscription rates: $1,197 per year in U.S., Canada, and Mexico; $1,262 elsewhere (air mail delivered). A 15% discount is available for qualified academic libraries and full-time teachers. For subscription information and customer service call (866) 425-1171 or visit our Web site at www.rscrpubs.com. General Editor: Michael O. Finkelstein; tel. 212-876-1715; e-mail mofinkelstein@hotmail.com. Associate Editor: Sarah Strauss Himmelfarb; tel. 301-294-6233; e-mail shimmelfarb@comcast.net. To submit a manuscript for publication contact Ms. Himmelfarb. ISSN: 0884-2426.

to that delegation. Recent Delaware cases confirm that the board of directors has a fiduciary duty to make decisions regarding the corporation's capital structure and generally may not delegate that decision-making authority to officers.[4] Accordingly, in the event the board determines that it would be impractical or unwieldy for it to take all actions necessary to implement an equity program following its establishment, the board should consider forming a committee, which may be composed of a single director, and delegating to such committee the power and authority to take all such actions.

BACKGROUND

Delaware law has long required the board of directors to fix the value of the consideration received in exchange for the issuance of capital stock.[5] The board's unique role in establishing the consideration for the issuance of capital stock is rooted in Delaware's longstanding (but now repealed) constitutional consideration requirements.[6] While Sections 152 and 153 of the General Corporation Law, read together, currently provide the board of directors with wide latitude in determining the nature, quality, and form of payment of the consideration received for the issuance of stock,[7] this grant of broad authority in determining the adequacy of such consideration represents a relatively recent development in Delaware law.

In 2004, the General Corporation Law and the Delaware Constitution were amended to eliminate the anachronistic requirements relating to the form of consideration for the issuance of stock.[8] Prior to the effectiveness of those amendments, the Delaware Constitution provided that corporations could issue stock only for money paid, labor done, or personal property, real estate, or leases actually acquired by the corporation,[9] and Section 152 of the General Corporation Law contained provisions mirroring these restrictions. These restrictions relate to a period during which a corporation's capital was viewed as a "permanent base of financing upon which creditors were

[4] We note that Section 157 of the General Corporation Law of the State of Delaware (the "General Corporation Law"), which deals with the creation and issuance of rights and options to purchase capital stock, authorizes the board to delegate certain powers to officers – namely, the power to determine which officers and employees of the corporation or its subsidiaries will receive rights or options and in what amounts, subject to certain limitations. 8 *Del. C.* § 157(c). There is no comparable grant of authority in the relevant provisions of the General Corporation Law dealing with the issuance or disposition of capital stock. 8 *Del. C.* §§ 152, 153.

[5] *See Bowen v. Imperial Theatres, Inc.*, 115 A. 918, 920 (Del. Ch. 1922).

[6] *Id.* ("The Constitution of this state provides that no corporation may issue stock except for money paid, labor done or personal property or real estate, or leases thereof actually acquired by the corporation. . . . Engaging to render future services cannot, under such a constitutional provision as we have, defining the things for which stock may be issued, be taken as consideration for the issuance of full-paid, nonassessable stock.").

[7] Sections 152 and 153 of the General Corporation Law set forth the requirements relating to issuance of capital stock and the board's determination of the adequacy of the consideration received for such stock. 8 *Del. C.* §§ 152, 153.

[8] Del. H.B. 399, 142nd Gen. Assem. (2004) (repealing Article IX, Section 3 of the Delaware Constitution and stating, in the synopsis to the legislation, that the bill "is the second leg of a Constitutional Amendment that eliminates the restrictions currently in place on the types of consideration that may be received in return for the issuance of stock"); S.S. 1 for Del. S.B. 272, 142nd Gen. Assem. (2004) (eliminating the consideration requirements in Section 152 in conformity with the amendment to the Delaware Constitution); *see generally* 1 R. Franklin Balotti & Jesse A. Finkelstein, *The Delaware Law of Corporations and Business Organizations* § 5.13 (3d ed. 2011 supp.) (hereinafter "Balotti & Finkelstein").

[9] Del. Const. of 1897, art. IX, § 3 (as reprinted in 5 *Debates and Proceedings of the Constitutional Convention of the State of Delaware*, 3503-04 (1958)) ("No corporation shall issue stock, except for money paid, labor done or personal property, or real estate or leases thereof actually acquired by such corporation; and neither labor nor property shall be received in payment of stock at a greater price than the actual value at the time the said labor was done or property delivered or title acquired.").

presumed to rely when extending credit"[10] and, accordingly, were intended to protect creditors and stockholders by preventing the issuance of stock with no consideration or with so little consideration that the corporation's capital would be far less than the amount represented by its issued and outstanding shares.[11] Subsequent developments in the area of corporate law effectively vitiated the initial purpose of the constitutional restrictions.[12] With the advent of no-par shares and shares with nominal par value, the constitutional and statutory provisions requiring the corporation to receive the par value for its stock were essentially denuded of their original significance.

The 2004 amendments have largely foreclosed challenges to the issuance of stock based on the nature of the consideration,[13] since the board may now issue shares for virtually any type of consideration, including binding promissory notes, future services or intangible benefits to the corporation.[14] But Delaware law continues to carve out a unique role for the board of directors in equity issuances, and challenges based on the board's failure to comply with statutory formalities in creating and issuing capital stock persist.

Olson v. ev3, Inc.

In *Olson v. ev3, Inc.*, the Court of Chancery confirmed the critical role of the board of directors under the General Corporation Law in decisions regarding changes to the corporation's capital structure.[15] The court's discussion in *ev3* arose in connection with its determination of the benefits conferred by a settlement of the litigation challenging the "top-up option" in the merger agreement through which Covidien Group S.a.r.l. would acquire ev3.[16] The stockholder plaintiffs challenged the top-up option on several grounds, including that it was not validly authorized under the General Corporation Law.[17]

The court found that the top-up option, along with the shares issued upon the exercise of that option, "likely were void" as originally structured.[18] The court then suggested that the validity of subsequent actions taken in reliance on the exercise of the option – such as the consummation of the short-form merger – would likewise be called into question.[19] Although the court was merely reciting its basis for granting the plaintiffs'

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[10] *SV Inv. Partners, LLC v. ThoughtWorks, Inc.*, 7 A.3d 973, 982 (Del. Ch. 2010).

[11] Balotti &Finkelstein, § 5.13 (citing 2 *Debates and Proceedings of the Constitutional Convention of the State of Delaware*, 891 (1958)).

[12] *See CML V, LLC v. Bax*, 6 A.3d 238 (Del. Ch. 2010). In *Bax*, the court explained that "legal capital … was considered a trust fund for the benefit of creditors," but noted that this doctrine has been "discredited and abandoned." *Id.* at 252, 253, n.10 (citing Ernest L. Folk III, Review of the Delaware Corporation Law for the Delaware Corporation Law Revision Committee, 254-55 (1965-67)).

[13] David A. Drexler et al., *Delaware Corporation Law and Practice* § 17.02 (2010 Supp.) ("Most cases involving challenges to the adequacy of consideration for the issuance of stock have involved questions as to the constitutional quality of the consideration received by the corporation – a question no longer significant for new issues of stock.").

[14] Prior to the 2004 amendments, future services did not satisfy the constitutional consideration requirements for the issuance of stock. But the Delaware courts had found that the prospect of such services could constitute adequate consideration for the issuance of stock options. *See, e.g., Zupnick v. Goizueta*, 698 A.2d 384, 387-88 (Del. Ch. 1997) ("Normally, stock options issued to employees are made exercisable at some future date after their issuance, in order to motivate the recipient to continue to perform valuable service for the corporation. That is, the consideration for stock options is often the reasonable prospect of obtaining the employee's valued future services. But that is not the only permissible form of consideration for a grant of stock options.") (internal citations omitted).

[15] 2011 WL 704409, at *12-13 (Del. Ch. Feb. 21, 2011).

[16] *Id.* at *3. A "top-up option" is a common feature in a two-step transaction in which an acquiror commences a tender offer for the target corporation's shares, which offer is to be followed by a back-end merger to cash out the shares of the target not acquired in the offer. If the acquiror obtains a certain percentage of outstanding shares from the tender offer (*e.g.*, 85%), the top-up option enables the acquiror to purchase additional shares of the target sufficient to reach the 90% ownership threshold required to effect the transaction as a short-form merger under Section 253 of the General Corporation Law. *See* 8 *Del C.* § 253; *Olson v. ev3, Inc.*, C.A. No. 5583-VCL (Del. Ch. June 25, 2010) (Transcript); *see generally In re Cogent, Inc. S'holder Litig.*, 7 A.3d 487, 504-08 (Del. Ch. 2010).

[17] *ev3,* 2011 WL 704409, at *6-7.

[18] *Id.* at *11.

[19] *Id.* at *11, *14. ("To the extent a short-form merger closed in reliance on the resulting shares, the validity of the Merger could be attacked. The invalidity of that transaction in turn could have called into question subsequent acts by the surviving corporation. . . . Deep faults could have developed in the ev3 corporate structure if the Top-Up Option Shares were found invalidly issued and the Merger invalidly consummated. The settlement administered a preventative cure.").

fee award following approval of the settlement,[20] its observations regarding the validity of the option, and the shares issued pursuant thereto, under the General Corporation Law are instructive.

First, the court noted that Section 157 of the General Corporation Law, which deals with the creation and issuance of stock options, requires the board to adopt a resolution establishing the terms of the option, including the consideration to be provided for the shares issued upon the exercise of the option, and further requires that the terms of the option be set forth in an instrument evidencing the option.[21] In this case, the top-up option was originally included in the merger agreement – which served as the instrument evidencing the option – but there was no evidence of a separate resolution fixing the terms of the option.

Second, under Section 157(d), the consideration to be received for shares issued upon the exercise of the option must have a value not less than the par value of the shares so issued. Here, the merger agreement provided that the consideration for the top-up shares could be paid with a note, but it failed to specify the terms of the note.[22] In fact, the merger agreement provided that Covidien would set the terms of the note. Because the terms of the note were not set at the time of the grant of the option, but could instead be established by the purchaser, the board could not make the determination regarding the sufficiency of the consideration received for the shares issued upon exercise of the top-up option.

This particular feature of the original merger agreement – the delegation to Covidien of the power to fix the terms of the note furnished as consideration – triggered a discussion of the "longstanding Delaware case law" requiring that "the board of directors determine the sufficiency of the consideration received for shares."[23] As support, the *ev3* court pointed to the Chancery Court's opinion in *Field v. Carlisle Corp*.[24] In that case, the court found that the board of directors could not delegate its duty to determine the value of the property received by the corporation as consideration for its stock.[25] In a similar vein, the *ev3* court pointed to *Jackson v. Turnbull*[26] – in which the court invalidated a merger on the grounds that the board had impermissibly delegated its power to fix the merger consideration – for the general proposition that the board of directors may not, through delegation or otherwise, abdicate its statutorily prescribed duties. Ultimately, it was of no consequence to the court that these defects were relatively minor and that all of the interested parties, including the board of ev3, understood the operation of the terms.[27]

Blades v. Wisehart

The importance of strict compliance with statutory formalities in the equity issuance arena was underscored just as starkly in *Blades v. Wisehart*.[28] *Blades* involved

[20] *Id.* at *11 ("By defusing a potential corporate landmine, [plaintiff] and her counsel conferred an unquantifiable but nevertheless significant corporate benefit on ev3 and its stockholders – and on Covidien and its stockholders as well.").

[21] *Id.* at *12.

[22] *Id.*

[23] *Id.*

[24] 68 A.2d 817, 820 (Del. Ch. 1949).

[25] *Id.* In *Field*, the board of directors of Carlisle Corp. entered into an agreement in which shares of Carlisle would be issued as consideration to acquire shares of Dart Truck Company. The agreement provided that the number of Carlisle shares issued as consideration for the Dart shares would be as determined to be fair and equitable by an independent appraiser, but not to exceed a maximum of 218 shares. Thus, while Carlisle's board of directors effectively fixed the upper limit on the consideration, it otherwise delegated its statutory and fiduciary duty to determine the exact amount of consideration it was willing to accept for Carlisle's shares. On this basis, the court enjoined the issuance of the shares. But the court did not entirely foreclose the possibility that the board could establish a range of value in which shares may be validly issued: "[E]ven if we assume that directors might discharge their duty of determining the value of property to be received in exchange for stock by fixing some range of value, rather than an exact figure, it is clear that we are not here confronted with that situation." *Id.* at 821.

[26] 1994 WL 174668, at *4-5 (Del. Ch. Feb. 8, 1994).

[27] *ev3*, 2011 WL 704409, at *13 ("The defendants have attempted to minimize the import of these statutory problems by suggesting that the directors understood the general nature of the Top-Up Option, its efficacy in speeding deal closure, and the lack of any prejudice to minority stockholders. That level of knowledge would be pertinent . . . to a breach of fiduciary duty claim attacking the board's decision to approve the Top-Up Option. If the board actually made a determination about the sufficiency of the consideration received, that level of knowledge also would be pertinent to the 'absence of actual fraud' standard found in Section 152 and Section 157. Knowing about the generalities of the transaction structure does not satisfy the explicit statutory requirements of Sections 152, 153 and 157(b) and (d)." (citations omitted)).

[28] 2010 WL 4638603 (Del. Ch. Nov. 17, 2010).

a dispute over control of Global Launch, Incorporated, an "internet layaway" corporation conceived and largely founded by Rusty Blades. Global's two initial stockholders were Rusty Blades and an Ohio corporation named The Ohio Company.

Global was in need of capital in its initial year, and its principals wanted to use shares to motivate and reward employees. Global's board accordingly attempted to effect a 5-for-1 forward stock split to increase the number of shares that could be offered for sale or as compensation. In this connection, Global's board adopted an amendment to the certificate of incorporation. But the certificate of amendment was not filed until months after the resolution approving the amendment was adopted. In any event, the late-filed certificate of amendment referenced only the increase in the authorized shares of capital stock – it contained no language effecting the split. Nonetheless, the parties proceeded as if the split had occurred.

In the ensuing months, Rusty Blades was forced out of the company after pleading guilty to a misdemeanor that it was believed would bring disrepute upon Global. While in exile from Global, Blades's former co-director (and Global's then-counsel) began transferring shares of stock held by Blades and The Ohio Company – which shares were believed by all parties to have been created in the forward stock split. In an attempt to regain control of the board, Blades called a meeting of stockholders to remove the directors and elect a new board, but in recognition that the meeting likely was not validly called, and with an increasing awareness of the problems with the subsequent stock transfers, Blades and The Ohio Company adopted a written consent removing all of the directors and naming a new board.

In the court's review of which directors were in fact validly in office, the relevant question was whether Blades and The Ohio Company were the only holders of valid shares of Global at the time the unanimous written consent was executed. The court agreed with Blades's position that the only shares that had been validly issued were those initially issued to Blades and The Ohio Company. The court summarized the steps required to effect a valid forward stock split by charter amendment: the board of directors must approve and declare advisable the amendment to the certificate of incorporation; the stockholders must adopt the amendment; and the amendment must be executed and filed with the Delaware Secretary of State. In this case, because the language effecting the stock split was not included in the certificate of amendment, the court declared that the shares that otherwise would have resulted from the split were invalid.

As with *ev3*, the court's ruling in *Blades* highlights the importance of complying with statutory formalities when changing the capital structure of a corporation – that is, defects in the authorization of stock may result in a finding that putative shares are in fact void. "The stock purportedly held by minority stockholders, having never been properly authorized through a valid stock split, is, to borrow a phrase from *STAAR*, 'void and a nullity.'"[29] Moreover, equitable considerations may not be used to validate otherwise defectively issued stock.[30] As articulated by the Delaware Supreme Court in *STAAR*, because the "issuance of corporate stock is an act of fundamental legal significance having a direct bearing upon questions of corporate governance, control and the capital structure of the enterprise," the law requires compliance with the statutory formalities.[31]

PRACTICAL IMPLICATIONS

As discussed above, the board of directors of a Delaware corporation, as a statutory matter, has virtually exclusive control over changes to the corporation's capital structure. The statutory regime reflects the public policy consideration that claims upon a corporation's equity are so important, and so fundamental to the corporation, that the issuance of shares representing those claims must be effected and documented with a high degree of formality.[32] Thus,

[29] *Blades,* 2010 WL 4638603, at *12 (citing *STAAR Surgical Co. v. Waggoner*, 588 A.2d 1130, 1136 (Del. 1991)).

[30] *Id.* ("But what is more critical is that *STAAR* and other binding precedent make clear that I cannot ignore the statutory infirmity of the stock split because my equitable heartstrings have been plucked. That is, in the sensitive and important area of the capital structure of the firm, law trumps equity."); *see also In re Native American Energy Group, Inc.*, 2011 WL 1900142, at *6 (Del. Ch. May 19, 2011) (dismissing petitioner's request for the court to determine, in the absence of an actual controversy, whether non-unanimous stockholder ratification would be effective to validate invalidly issued shares and noting that in *STAAR*, "[t]he Delaware Supreme Court refused to 'trivialize' compliance with the statutory requirements by invoking equitable considerations and 'emphasize[d] that our courts must act with caution and restraint when granting equitable relief in derogation of established principles of corporate law.'") (citations omitted). For an expanded discussion of the effect of defects in stock issuances, *see* C. Stephen Bigler & Seth Barrett Tillman, *Void or Voidable? – Curing Defects in Stock Issuances Under Delaware Law*, 63 Bus. Law. 1109 (2008).

[31] 588 A.2d at 1136.

[32] *See also Kalageorgi v. Victor Kamkin, Inc.*, 750 A.2d 531, 537-38 (Del. Ch. 1999) ("[O]ur statutory scheme envisions a model

when the board issues stock, it should do so with care and its deliberations should be appropriately documented, including its determination that the benefit received by the corporation for the issuance of such shares, regardless of the form, has a value not less than the par value of such shares.[33]

The question remains, how can a board of directors effectively manage the corporation's capital structure? In most large corporations, the board of directors delegates to the officers the primary responsibility for managing day-to-day affairs. But the board's ability to delegate is limited when it comes to stock issuances, including in the case of equity programs. Read expansively, the court's statements in *ev3* suggest that, even if the board has established the broad parameters of an equity program (*e.g.*, over the next 18 months, up to 1,000,000 shares of common stock may be issued, in blocks of not more than 50,000 shares per day, and not more than 500,000 shares in any quarterly period, at the prevailing market price at the time of issuance, which price shall not be less than $5.00 per share), a delegation to one or more officers to fix the number of shares issued (and, by reference to the prevailing market price at the time of issuance, the consideration received therefor) may not be effective. Were that structure found to be ineffective, the consequences, based on *ev3* and *Blades*, could be dramatic. Accordingly, if a board of directors believes it needs to delegate the power to issue stock, whether in connection with an equity program or otherwise, it should form and properly empower a committee of the board consisting of one or more directors.[34] ■

footnote continued from previous page…

for the issuance of corporate securities that is premised upon a certain degree of formality, specifically, formal board authorization to issue stock at a duly called meeting of directors, or in lieu thereof, by unanimous written consent. Delaware case law is in accord with, and supportive of, that model.").

[33] 8 *Del. C.* §§ 152, 153; *Grimes v. Alteon, Inc.*, 804 A.2d 256 (Del. 2002) ("As noted, Section 152 requires the directors to determine the 'consideration ... for subscriptions to, or the purchase of, the capital stock' of a corporation. Thus, director approval of the transaction fixing such consideration is required."). While the board is not required to undertake a formal valuation, it must exercise its overall duty of care. *See Leung v. Schuler*, 2000 WL 264328, at *9 (Del. Ch. Feb. 29, 2000) (noting that "[t]he Delaware General Corporation Law grants a board of directors considerable discretion in determining the consideration for the issuance of stock" and stating that, in considering the value of services rendered, Section 152 does not "require that the board conduct a 'formal valuation'"of such services). The board's judgment as to the adequacy of the consideration will be deemed to be "conclusive" in the absence of "actual fraud." 8 *Del. C.* § 152. To demonstrate actual fraud, a plaintiff would be required to show an overvaluation amounting to constructive fraud as well as allegations or other facts sufficient to provide a basis for actual fraud. An excessive valuation, however, may be sufficient to show actual fraud if it is sufficiently gross to indicate bad faith or reckless indifference on the part of the directors. *Lewis v. Scotten Dillon Co.*, 306 A.2d 755, 757 (Del. Ch. 1973). In addition, the "actual fraud" requirement may not apply in the event that directors are personally interested in the transaction. *See Parfi Holding AB v. Mirror Image Internet, Inc.*, 794 A.2d 1211, 1234-35 (Del. Ch. 2001), *rev'd on other grounds*, 817 A.2d 149 (Del. 2002); *Lofland v. Cahall*, 118 A. 1, 8 (Del. 1922); Balotti & Finkelstein, § 5.28. The Delaware courts have suggested that a recitation set forth in the resolutions or the consent authorizing a stock issuance stating that the corporation has received adequate consideration for such issuance would constitute sufficient evidence of the board's determination thereof. *See generally Ueltzhoffer v. Fox Fire Development Co.*, 1991 WL 271584, at *6 (Del. Ch. Dec. 19, 1991).

[34] 8 *Del. C.* § 141(c).