

CORPORATE LITIGATION:

VALIDATING DEFECTIVE CORPORATE ACTS UNDER DGCL SECTIONS 204 AND 205

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Under the common law, the Delaware Supreme Court held that the Court of Chancery's equitable powers did not reach so far as to permit ratification of corporate action, including stock issuances, found to be legally "void" under the governing organizational documents or the Delaware General Corporation Law (DGCL). This rule often carried harsh consequences, particularly in the case of technical violations of statutory requirements. In 2014, the Delaware legislature superseded these rulings by enacting DGCL Sections 204 and 205, which authorize the directors of a corporation, its shareholders, and/or the Court of Chancery to remedy defective corporate acts if certain procedures are followed.

The availability of the statutory cure turns on the distinction between actions taken without appropriate *authorization*, which may be ratified and/or validated pursuant to Sections 204 and 205, and those taken in the absence of corporate *power*, which may not. Vice Chancellor J. Travis Laster's decision last week in *Applied Energetics v. Farley*, No. CV 2018-0489-JTL, 2020 WL 4432271 (Del. Ch. Aug. 3, 2020), reviewed the text and history of the legislation and clarified that its provisions empower the court to cure not only corporate acts suffering from technical mistakes or lapses, but also most other acts taken without the required approval of directors, officers, or shareholders.

Background

In *STAAR Surgical Co. v. Waggoner*, 588 A.2d 1130 (Del. 1991), the Delaware Supreme Court reversed the Court of Chancery's authorization of two million shares of common stock issued to the corporation's former CEO and president, rejecting arguments that the corporation's failure to issue the shares in conformity with the DGCL was a mere technical error that could be remedied through the Court of Chancery's equitable powers. As the Court of Chancery later put it, the Delaware Supreme Court's requirement of "scrupulous adherence to corporate formalities" meant that the Court of Chancery lacked power to ignore a corporation's noncompliance with statutory requirements, even where chancellors' "equitable heartstrings have been plucked." *Blades v. Wisheart*, No. C.A. 5317-VCS, 2010 WL 4638603, at *12 (Del. Ch. Nov. 17, 2010).

Amendments to the DGCL enacted in 2013 and made effective in 2014 superseded this line of precedent, providing both "self-help" and judicial mechanisms to cure corporate actions that are otherwise void. Under Section 204(a), the board of directors and/or shareholders may ratify defective corporate acts or putative stock issuances, or the Court of Chancery may validate such acts, if the defect is "solely as a result of a failure of authorization." The remaining provisions of Section 204 describe the procedures to be followed to effect

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ratification. Section 205 codifies the Court of Chancery’s equitable power to provide relief, by empowering the corporation, its directors, shareholders, or other affected persons to seek (1) judicial review of the validity of a purported ratification under Section 204, or (2) where a ratification under Section 204 cannot be made or has not been made, a determination by the Court of Chancery itself as to the validity of the defective corporate act. Together, Sections 204 and 205 provide a number of avenues to retroactively cure corporate actions void under governing law or the corporation’s own organizational documents.

In the view of many courts and commentators, “Section 205 fundamentally concerns a company having taken an act with the intent and belief that it is valid and later petitioning the Court to correct a technical defect and thereby remedy incidental harm.” *In re Genelux Corp.*, 126 A.3d 644, 669 (Del. Ch. 2015), *vacated in part sub nom. Genelux Corp. v. Roeder*, 143 A.3d 20 (Del. 2016). As initially enacted, Section 204(h)(1) defined a “defective corporate act” subject to ratification or validation as (1) “an overissue, an election or appointment of directors that is void or voidable due to a failure of authorization,” or (2) “any act or transaction purportedly taken by or on behalf of the corporation that is, and at the time such act or transaction was purportedly taken would have been, within the power of a corporation under subchapter II of this chapter, but is void or voidable due to a failure of authorization.”

In *Nguyen v. View, Inc.*, the Court of Chancery interpreted Section 204 to preclude ratification and validation of a corporate act where its majority shareholder had deliberately declined to approve it, reasoning such an act was not within the power of the corporation “at the time such act ... was purportedly taken.” C.A. No. 11138–VCS, 2017 WL 2439074 (Del. Ch. Ct. June 6, 2017), *reargument denied*, 2017 WL 3169051 (Del. Ch. July 26, 2017). Narrowly read, *Nguyen* holds that a corporation cannot claim a corporate act was defectively authorized when it was, in fact, considered and rejected. But to foreclose a broader reading that would significantly limit Section 204’s scope, the legislature amended the provision in 2018 to clarify that the failure to *approve* a defective corporate act in accordance with the DGCL does not preclude ratification or validation under Sections 204 and 205, respectively: Failure to secure necessary approvals is a “failure of authorization,” not an act outside the corporation’s power. Section 204(h)(1) now makes clear that a defective act subject to Sections 204 and 205 is one that was within the power of the corporation “without regard to the failure of authorization” that renders it defective.

‘Applied Energetics’

Last week’s decision in *Applied Energetics v. Farley* further clarifies the distinction between corporate acts lacking authorization and those lacking corporate power. The litigation involves a dispute between a defense and security products company and former director and principal executive officer George Farley, who became its sole director and officer following a period of significant decline in its financial condition and suspension of its business operations. Farley issued to himself 25 million shares of common stock and authorized his six-figure salary pursuant to written consent documents he signed as sole director and sole member of the compensation committee.

The company challenged the self-interested compensation, and the Court of Chancery agreed with the company that Farley’s actions were defective and invalid. The DGCL and the company bylaws required a quorum—a majority of the three-member board then required by the company’s organizational documents—to effect the issuances and pay salaries, and Farley alone did not constitute a quorum. Where director vacancies preclude reaching a quorum, the DGCL authorizes the director(s) in office to fill the vacancies—but nothing else. Farley’s argument that Section 141(f) of the DGCL permits unanimous action of the board of directors by written consent was unavailing, as the provision “is not a vehicle for directors to avoid the requirements of a meeting. It is a vehicle for directors to use when they could satisfy the requirements for action at a meeting but the consensus is unanimous and thus a meeting is unnecessary.” 2020 WL 4432271, at *15.

The Court of Chancery declined to award the company summary judgment on Farley’s counterclaims, holding that his invalid acts could be validated pursuant to Section 205 and must be resolved at trial. Farley’s actions were within the corporate power to issue shares and compensate officers, even though the actions were taken without the authorization by the board of directors required by the DGCL and bylaws. As the court explained, “the concept of corporate power refers to whether the entity has been granted the ability to engage in a given act” whereas “authorization refers to whether the proper intra-corporate actors or combination of actors, such as the corporation’s officers, directors, or stockholders, have taken the steps necessary to cause the corporation to take the given act.” *Id.* at *25. Importantly, corporate power is vested under Section 121(a) of the DGCL collectively upon the corporation, its officers, shareholders, and directors. Thus, whether the appropriate actors (directors, officers, or shareholders) have complied with the division of responsibilities required by the corporate organizational documents is a question of authorization, not power. In the case of Farley’s unilateral actions to issue stock and award compensation, the absence of a quorum was a failure of authorization, not of corporate power.

In so holding, the Court of Chancery explained that *Nguyen v. View*, as clarified by the 2018 amendments to Section 204, distinguished between a defective corporate act (e.g., one taken without the approval of the board and/or shareholders), and a rejection (e.g., action taken after the shareholders declined to approve a transaction). The latter is outside the scope of Section 204. So understood, *Nguyen v. View* is compatible with the central distinction embedded in Section 204 between corporate power and corporate authorization.

Conclusion

Much of the case law and commentary about Section 204 and 205 of the DGCL have concerned mistakes and/or technical violations of statutory requirements. *See, e.g., Cirillo Family Tr. v. Moezinia*, No. CV 10116-CB, 2018 WL 3388398, at *9 (Del. Ch. July 11, 2018) (validating a failure to properly date written shareholder consents to a merger, “the epitome of a technical shortcoming that the Delaware General Assembly sought to address when it promulgated Section 205”), *aff’d*, 220 A.3d 912 (Del. 2019); *Almond for Almond Family 2001 Tr. v. Glenhill Advisors LLC*, No. CV 10477-CB, 2018 WL 3954733, at *21 (Del. Ch. Aug. 17, 2018) (validating a defective stock split where the alternative would result in “an inequitable windfall for technical defects”), *aff’d*, 224 A.3d 200 (Del. 2019).

The recent decision in *Applied Energetics* illustrates that the remedies of ratification and validation in DGCL Sections 204 and 205 are available, on their terms, not merely to mistakes or lapses discovered after the fact, but other acts lacking appropriate statutory or organizational authorization. It further teaches that litigants opposing validation of defective corporate acts may not defeat application of the statute by conflating lack of approval by directors and/or shareholders with a lack of inherent power by the corporation. On the other hand, Sections 204 and 205 provide equitable solutions to otherwise incurable defects; not license to dispense with corporate formalities. With these principles in mind, Vice Chancellor Laster’s decision reconciles his expansive understanding of corporate power under the DGCL with *Nguyen v. View*’s holding that defective acts taken notwithstanding rejection by necessary corporate decision-makers are outside the reach of validation.