Recent Delaware Decision Highlights Importance of Formalities in Issuing Stock and Potential Utility of New Statutory Ratification Procedures

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Late last year, Vice Chancellor John Noble of the Delaware Court of Chancery issued a decision in Boris v. Schaheen that highlights the importance of following formalities when issuing stock. The decision found an array of purported stock issuances to be invalid and held that the invalid issuances could not be “ratified”—i.e., retroactively validated. In the decision, Vice Chancellor Noble made broad statements about defects relating to the issuance of stock and when and whether such defects can be ratified, which could be viewed as limiting the ability of corporations to ratify certain defects under the Delaware case law, at least in the stock issuance context. Importantly, if attempted stock issuances are void because a corporation did not follow the proper formalities and those issuances are not properly ratified or cannot be ratified, a person thought to own the related stock is not actually a stockholder. The principles from this case could apply as well to the grant of stock options and other similar awards.

The decision also underscores the potential utility of new Sections 204 and 205 of the Delaware General Corporation Law (DGCL), which go into effect on April 1, 2014. Sections 204 and 205 are intended to provide a path by which corporations, using statutory procedures, can ratify defective corporate acts, including stock issuances, that may otherwise be incapable of ratification under the case law.

Background

Delaware law requires that corporations follow certain procedures when issuing stock. Generally, Delaware law views stock issuances as “within the exclusive control” of the board of directors and imposes the following requirements:

- The board of directors must approve stock issuances in a written instrument, either by resolution at a properly held meeting or by unanimous written consent.
- The company must receive sufficient consideration in return for stock.
- The company should generally maintain a proper stock ledger.
- The board of directors must also approve the grant of stock options and stock rights, as well as the terms of such awards and the instruments evidencing them. The board of directors can delegate to officers the authority to grant stock options and other rights to acquire stock to employees if the board of directors and the company follow certain requirements specified in the DGCL.

Under current Delaware case law, certain defective corporate acts are “void,” whereas others are “voidable.” The distinction between “void” and “voidable” corporate acts has long been a concern of practitioners because acts that are merely “voidable” may be ratified, whereas those that are “void” may not. The Delaware case law provides that, at least in some instances where companies fail to follow proper procedures in undertaking corporate acts, including with respect to stock and other equity issuances, those acts can potentially be ratified—
for example, by an informed vote of the board of directors to validate the defective acts retroactively. Historically, the question of whether a defective act is one that is “voidable” and can be ratified—versus simply being “void” from the outset—has been governed by an array of cases that often do not lead to a clear answer.

Unfortunately, questions concerning the validity of a corporation’s stock often arise in pivotal moments—for example, when a battle over control emerges along with a dispute over who actually owns stock and can remove and elect directors (as in *Boris v. Schaheen*), or when a company embarks on a major transaction such as an IPO or sale and requires a legal opinion about its prior corporate acts. Although *Boris v. Schaheen* arose in the context of a small, private company that informally conducted its internal affairs and had extensive problems surrounding its attempted stock issuances, in our experience, companies of all kinds and sizes encounter issues concerning the propriety of their stock issuances and grants of stock options, restricted stock, and similar awards.

**The New *Boris v. Schaheen* Decision**

*Boris v. Schaheen* arose in the context of a dispute over control of a small, private company and a related company (originally intended to be a subsidiary). Two purported stockholders attempted to replace each company’s board of directors, which in turn led to a dispute over who validly held stock and could remove and appoint directors. Delving into the companies’ stock issuance history, the Court of Chancery noted that the companies informally conducted board meetings, never providing proper notice of the meetings, maintaining minutes, or keeping any records of formal votes taken by the directors. Significantly, in what became a principal focus of the case, the purported board approvals of the companies’ stock issuances were not reflected in any written instrument—i.e., board resolutions or a unanimous written consent of the board of directors. Instead, the directors informally approved issuances loosely based on the intended “percentage ownership” of the companies. The companies originally designated official stock ledgers, but the companies did not maintain those ledgers and instead used electronic spreadsheets—the accuracy of which was in dispute and which the directors never formally adopted as the replacement stock ledgers of the companies. In addition, the governance, board meetings, and records of the two companies were generally commingled. In one case, one of the companies issued a stock certificate to an employee signed by the directors, but the issuance was not formally approved and the stock certificate listed an erroneous class of stock. At another point, the directors attempted to ratify their prior acts in general terms but did not specifically approve any of the attempted stock issuances. However, with respect to most of the purported stock issuances, contemporaneous documentation indicated that the directors had intended to issue many shares of each company’s stock.

The court noted that the DGCL contemplates “a formal approach to corporate governance, particularly for changes to the corporation’s capital structure” and that “[s]tock is not validly issued unless the board of directors exercises its power [to issue stock] in conformity with statutory requirements.” The court focused on the statutory requirement of a written instrument adopted by the board of directors to evidence the issuance under *Section 151(a)* and other provisions of the DGCL, either by board resolutions or by written consent. The court noted that this requirement should be enforced in a “strict” manner because this “formality maintains the integrity of the stockholder franchise under Delaware corporate law,” “facilitates investment in stock,” which is the “critical component” of wealth creation, and discourages “a repeat of situations…in which uncertainty is heaped on uncertainty, with the result being a jumbled corporate mess.” The failure to comply with such a requirement, as in this case, rendered the stock “void,” a nullity such that “it cannot be remedied by equity.” Further, the court found that although the board of directors might have *informally* decided to issue stock and the directors and stockholders might have acted as though stock had been issued, “even a shared understanding of what was intended is insufficient to satisfy the DGCL’s strict requirement of a written instrument.”

The court concluded that only one of the companies had ever validly issued stock—in its initial “founder” issuances, which the parties had stipulated were valid. The court determined that the other company had no valid stock or stockholders at all. Importantly, the court further concluded that flaws of the kind before it could not be ratified and that the court could not apply the remedy of estoppel to recognize the issuances.
Practical Implications

*Boris v. Schaheen* is a significant case addressing a basic corporate law matter—the implications of flawed common stock issuances—that has been infrequently addressed in modern Delaware case law, and thus, the case is an important new point of reference for Delaware corporations and their advisors. In our experience, some of the questions that commonly arise relating to whether a corporation has properly issued stock or granted stock options and similar awards include the following:

- Did the board of directors and corporation follow proper procedures, including receipt of required approvals?
- Did the corporation receive adequate consideration in return for the issuance or grant?
- In the case of stock options and other awards by board committees or officers, did the committee or officers have proper authority to grant the awards (i.e., was the delegation done properly and did the committee or officers have authority to grant the types of awards in question)?
- When stock is issued following an amendment to a certificate of incorporation implementing a new class of stock or a stock split occurs, did the corporation follow the proper procedures for adopting the amendment, including obtaining proper approvals?

Historically, where a defect arose in one of these areas, whether the defect could be ratified and validated in reliance on Delaware case law would depend on the various facts and circumstances of the defects in question. Corporations seeking to ratify defective acts in reliance on the Delaware case law now must also carefully consider *Boris v. Schaheen*.

**DGCL Sections 204 and 205**

Last summer, the Delaware legislature adopted, and the governor signed into law, two new provisions of the DGCL that are intended to provide a clearer path to ratifying “defective corporate acts” and issuances in most circumstances—including where the case law previously did not permit ratification or was ambiguous about whether ratification would be permissible. These provisions go into effect on April 1, 2014. **Section 204** will allow a corporation to ratify various applicable defective corporate acts, including stock issuances, if the corporation follows particular procedures, including, among other things, approval by the board of directors, notice to stockholders, and, in certain cases, approval by stockholders. **Section 204** imposes many procedures that will need to be carefully followed and, notably, is a new, untested provision. However, it will provide corporations with a potentially more certain path for resolving difficult problems and clarifying uncertainties. **Section 205** will give the Delaware Court of Chancery equitable jurisdiction and authority to validate and adjudicate defective corporate acts and to determine whether defects were properly ratified.

**Conclusion: Corporate Formalities Matter and the Impact of DGCL Sections 204 and 205 Remains to Be Seen**

The *Boris v. Schaheen* decision makes it clear that corporate formalities remain extremely important under Delaware law, particularly in the context of issuing stock and equity awards. Failure to follow corporate formalities may result in material, negative consequences, including concerns about the most fundamental issues relating to a corporation's existence. Corporations should regularly consult with their advisors to ensure that their practices relating to stock matters are in compliance with applicable law. Where defects are identified and ratification is the desired path for fixing those defects, Delaware corporations will need to weigh carefully with their advisors whether the defects can be remedied by the use of basic common law ratification—i.e., after-the-fact proper approval by directors and/or stockholders—or, beginning in April, whether the statutory ratification procedures set forth in **Sections 204** and **205** are more appropriate.

**OTHER CORPORATE DEVELOPMENTS**

[¶3.2] Minority shareholders barred from seeking damages—Cal—The California Court of Appeal has held that the California Corporations Code prevented dissenting minority shareholders from seeking damages for
an alleged breach of fiduciary duty in a common control merger. As the statute does permit suits by minority shareholders to set aside or rescind mergers in common control situations, however, the appellate court reversed and remanded the case for a resolution of that question.

**Background and allegations.** The plaintiffs were former minority shareholders in United Panam Financial Corp. (Panam Financial), a publicly traded company engaged in the business of making subprime loans on used cars. After Panam Financial's stock price dropped precipitously during the 2008 recession, a group which included the company's alleged controlling shareholder, Guillermo Bron, allegedly developed a management buyout scheme in order to take the company private for their personal benefit. Bron, who owned 38 percent of the stock and controlled the board of directors, allegedly set up an independent, special committee that valued the stock at a bargain price.

After the shareholders approved the buyout by the Bron Group on the board's recommendation, the plaintiffs brought separate actions, which were later consolidated, alleging a breach of fiduciary duty by the board. The plaintiffs sought rescission, but asked for rescissionary damages in the alternative. The trial court sustained the Bron Group's demurrer to the complaint, however, reasoning that: (1) Corporations Code Sec. 1312(b) does not allow for damages, even under the rubric of "rescissionary damages"; and (2) the complaint did not sufficiently allege that Bron had common control. The minority shareholders then appealed.

**Statutory rights of minority shareholders.** The appellate court noted that Corporations Code Sec. 1312 generally governs the rights of minority shareholders who dissent from mergers and buyouts. Under the California Supreme Court's ruling in *Steinberg v. Amplica* (1986), Sec. 1312(a) limits the rights of dissenting minority shareholders to an independent appraisal of the value of their shares. No published case, however, has confronted the problem of how Sec. 1312(b)—which involves buyouts when parties to a merger are under common control—interacts with Sec. 1312(a).

The plaintiffs asserted that Sec. 1312(b) should be read to allow dissenting minority shareholders in common control situations all common law rights, including the right to sue the majority owners and collaborating board members for damages arising out of a breach of fiduciary duty. The defendants, however, asserted that Sec. 1312(b) provides a more narrow exception. Under the defendants' reading of the statute, Sec. 1312(b) provides dissenting minority shareholders in common control situations with the additional right of having a merger itself set aside or rescinded, but does not give them the right to sue for damages for breach of fiduciary duty.

**Common control.** As a threshold matter, the appellate court ruled that the minority shareholders sufficiently alleged that Bron and his fellow directors possessed common control over the parties to the merger. As Sec. 1312(b) provides that common control can be founded on even indirect control, allegations that Bron controlled approximately 40 percent of the company's stock and served as the chair of the board were sufficient to support an inference of at least indirect control. Moreover, the complaint alleged that the other directors owed their jobs to Bron, and thus were economically dependent on him. Accordingly, the complaint sufficiently alleged common control.

**Damages.** The appellate court held, however, that Sec. 1312 does not allow dissenting minority shareholders in common control situations to seek damages. After tracing the legislative and judicial history of Sec. 1312 and its predecessor statutes, the court found the meaning of Sec. 1312(a) to be "unmistakable." Namely, disappointed minority shareholders generally cannot sue to stop or rescind a merger, and they are limited to the remedy of appraisal. Appraisal provides an adequate remedy because the appraisal can take into account breaches of fiduciary duty by corporate insiders.

The appellate court then examined what the legislature intended when it enacted the limited exception for common control situations under Sec. 1312(b). Reading Chapter 13 of the Corporations Code as a whole, the appellate court identified a "unified theory" of how the California legislature elected to treat dissenting minority shareholders in corporate reorganizations: In non-common control situations, dissenting minority shareholders have the remedy of appraisal but do not have the remedy of stopping or rescinding the reorganization. In common control situations, dissenting minority shareholders still have the remedy of appraisal unless they elect...
the remedy of stopping or rescinding the reorganization, but they never have the remedy of seeking monetary damages.

Set aside remedy. The appellate court found, however, that although the minority shareholders had no claim for monetary relief, they had never given up at trial their alternative request to set aside the buyout. The court observed that resolution of the case might involve valid defenses to the minority's efforts to undo the transaction. Moreover, in common control situations, Sec. 1312(c) shifts the burden of showing that the buyout was just and reasonable to the party who has control. Accordingly, the appellate court affirmed the judgment below to the extent that it precluded the plaintiffs from seeking any damages remedy, but reversed the judgment to the extent that it precluded the plaintiffs from seeking to unwind the buyout. 


Challenged transactions—Nev—The Nevada Supreme Court has affirmed a lower court's dismissal of consolidated shareholder derivative actions. The district court found that demand was not excused and dismissed the complaint without prejudice. The Nevada Supreme Court found that the appellants failed to demonstrate a reasonable doubt as to whether a majority of the defendant's directors were independent.

Background. Appellants Charles Kim and Sanjay Israni brought this action against current and former officers and directors of MGM Resorts International (MGM). Among other claims, the appellants alleged that the executives issued false and misleading statements, and sold MGM stock based on insider information. The defendants moved to dismiss based on failure to serve pre-suit demands on the board of directors. The district court found that demand was not futile and not excused.

Appeal. On appeal, Kim and Israni argued that the district court's conclusion was improper because five board members were interested in the allegedly illegal stock sales. The appellants argued further that an additional two directors were beholden to director Kirk Kerkorian. Therefore, the appellants maintained, seven out of 14 directors were interested.

The court concluded that it was irrelevant that two directors were allegedly beholden to Kerkorian, because the appellants did not allege that Kerkorian himself was interested in any of the challenged transactions. Next, the appellants failed to identify any other directors interested in the illegal stock sales, and the interest of five directors in those sales did not establish that they were interested in any other challenged transaction. Therefore, the appellants failed to demonstrate a reasonable doubt as to whether a majority of the directors could exercise independent judgments when considering a pre-suit demand, the court found. Accordingly, the court concluded that the district court did not err in dismissing the case. Kim v. MGM Mirage, No. 61101 (Nev. December 30, 2013).

Shareholder's fraud claim—S.D.N.Y.—The United States District Court for the Southern District of New York granted the Bank of America Corp., JP Morgan Chase & Co., and Wells Fargo & Co.'s (defendants, collectively) motion to dismiss the plaintiff-shareholder Daniel Ravicher's complaint. The court determined that Ravicher failed to state a claim because the defendants' actions, even if proved, were too remote from Ravicher's alleged injury to show a causal connection.

Case history. The defendants provided a line of credit to Herbalife, Ltd. Thereafter, Ravicher bought put options in Herbalife stock, referring to the put options as a "short position." The stock soon became worthless.

Ravicher filed this complaint, alleging that the defendants injured him by providing a line of credit to Herbalife, thereby preventing Herbalife from collapsing as a natural result of it being a "fraudulent pyramid scheme because it has a compensation program based primarily on...the recruitment of new participants, not on the retail sale of products and services." Ravicher also alleged that "but for the defendants' conduct, his investment in a short position in Herbalife would be worth substantially more."

Ravicher's claim implausible. The court granted the defendants' motion to dismiss, stating that Ravicher failed to prove that his purchase of the puts imposed on the defendants a duty (to Ravicher) to refrain from assisting Herbalife in its business. The court specifically determined that because Ravicher purchased the puts after the defendants' provided Herbalife with the line of credit, Ravicher bought the puts so that he might profit from
Herbalife’s failure. The court therefore concluded that the defendants’ did not owe him a duty to refrain from extending the line of credit, citing the *volenti non fit injuria* principle that one who knowingly and voluntarily risks danger cannot recover from the resulting injury. *Ravicher v. Bank of America*, No. 13 Civ. 3908 (LLS) (S.D.N.Y. January 17, 2014).

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2. *Id.* at 38.
3. *Id.* at 34-35 (internal citations omitted).
4. *Id.* at 38-39 (internal citations omitted).
5. *Id.* at 39.
6. *Id.* at 44.
7. A “defective corporate act” is defined in *Section 204 of the DGCL* as “an overissue, an election or appointment of directors that is void or voidable due to a failure of authorization, or 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…but is void or voidable due to a failure of authorization.”