

Delaware Law to Provide for Ratification of Defective Corporate Acts as of April 1, 2014

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It is quite common during the course of legal due diligence to discover that a target company has issued more stock than it had legally authorized through its **certificate of incorporation**. Many companies, particularly emerging growth companies, are often too preoccupied with ambitious growth plans and raising critical private capital and overlook basic corporate housekeeping. Or they dole out lots of equity to employees and business partners in order to conserve much needed cash, but forget that there is actually a legal limit to the number of shares they can grant. These and other legal flaws, or “**defective corporate acts**,” can exist undetected for years in privately held companies, but they come to light at the worst possible time – when the company is being sold or when a significant capital raise is being undertaken. Previously, the lawyers would advise that these past errors placed a troublesome legal cloud over the company that presented risks that could not be eliminated, which often resulted in potential acquirors or investors simply abandoning a proposed transaction.

Fortunately, beginning April 1, 2014, new Sections 204 and 205 of the **Delaware General Corporation Law** (DGCL) will provide corporations with two clear mechanisms to rectify defective corporate acts. New Section 204 sets forth “self-help” procedures for corporations to ratify defective corporate acts, and new Section 205 vests the Court of Chancery with jurisdiction to hear and determine the validity of any potentially defective corporate act. These two provisions make it so that no defective corporate act will be potentially invalid “solely as a result of a failure of authorization,” if the act is ratified in accordance with Section 204 or validated by the Court of Chancery in a proceeding brought under Section 205.

The new law will apply to all corporate acts that are within a corporation’s power under the DGCL, but that are defective, whether due to a failure to obtain the requisite authorization, or a violation of the corporation’s certificate of incorporation, bylaws or any contract to which the company was a party, and where such failure or violation renders the act potentially invalid under Delaware law.

Section 204

In order to ratify a defective act under Section 204, a company’s board of directors must adopt a resolution that includes, among other things: (i) the time of the defective act; (ii) the nature of the failure of the authorization; and (iii) approval by the board of the ratification of the defective act. If the defective act relates to the unauthorized issuance of stock (putative stock), the resolution must also

specify the number and type of shares of putative stock issued and the date or dates when the shares were purported to have been issued. If stockholder approval was originally required under the DGCL, the company's certificate of incorporation or bylaws, or by contract, then the board must submit the ratifying resolutions to the stockholders for approval. Section 204 also sets forth the notice, quorum and approval requirements for the stockholder vote.

Once the applicable approvals are obtained, if the original act would have required a filing under the DGCL (e.g., a certificate of amendment or certificate of designations), then the corporation must make a new filing called a "certificate of validation" with the Delaware Secretary of State, which will provide a public record that the corporation has ratified the defective act pursuant to Section 204. In addition, the corporation must provide notice of any ratification effected without stockholder approval to all then-current holders of valid and putative stock and all holders of valid and putative stock as of the date of the defective corporate act to be ratified (to the extent such holders can be determined from corporate records).

Unless the ratification is challenged in court, following these procedures will magically erase the legal flaw and (i) each defective act ratified will be deemed effective retroactively to the time of the original defective corporate act, and (ii) each share of putative stock issued pursuant to a ratified defective act will be deemed to be an identical share of outstanding stock as of the time it was issued.

Section 205

Ratification under Section 204 may not always be available. For example, if a board of directors was elected with putative stock, then the election could be invalid and the board could be acting outside the scope of its proper authority. In such a case, the company can turn to the Court of Chancery for ratification of the putative stock and affirmance of the board's authority. Under new Section 205, the Court of Chancery is vested with broad authority to determine the validity and effectiveness of any corporate act or transaction and any stock rights or options to acquire stock. These claims may be brought by the corporation (or its successor entity), a director, any record or beneficial owner of valid or putative stock (including those holding stock at the time of the defective corporate act), among others.

In sum, these two provisions in the DGCL will provide a clear pathway out of what otherwise could be deal-killing legal mess. Corporations, and the attorneys asked to render opinions on the validity of past corporate actions, can take comfort that there exists now statutory mechanisms to avert a historically troublesome area of corporate law.

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