

A background image showing three business professionals in a modern office setting. Two men in suits are shaking hands, and a woman in a business suit stands to the right holding a tablet. The scene is brightly lit with large windows in the background.

Chancery Court Clarifies DGCL Section 204 Cannot be Invoked to Ratify Deliberately Unauthorized Corporate Acts

DGCL Section 204 Is Not a Time Machine
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In a memorandum opinion issued on June 6, 2017, the Delaware Court of Chancery (the Court) addressed an issue of first impression: whether an act that the majority common stockholder entitled to vote thereon declined to authorize, but that the corporation nevertheless pursued, may be deemed a “defective corporate act” subject to ratification under Section 204 of the Delaware General Corporation Law (DGCL).[1] The Court in *Nguyen v. View, Inc.* denied relief to the defendant corporation, distinguishing between ratifying mistakes and rewinding the clock to rewrite history.

The opinion provides a helpful discussion of the scope of statutory ratification under Section 204 and clarifies the difference between a “defective corporate act” resulting from a “failure of authorization” and a prior deliberate disapproval or rejection of a corporate action.

BACKGROUND

In 2007, Defendant View, Inc. (View), a smart glass manufacturer, accepted a Series A investment from two venture capital funds, Sigma Partners Ventures (Sigma) and Khosla Ventures (KV). As a result of the financing, Sigma and KV held 50% of View’s equity on a fully-diluted basis and 62% of View’s outstanding shares. After the Series A financing, Plaintiff Paul Nguyen (Nguyen), View’s founder, President, Chief Technology Officer, and member and Chairman of the Board of Directors (the Board), held approximately 70% of View’s outstanding common stock, which represented about 30% of View’s equity on a fully-diluted basis. Nine months later, KV and Sigma increased their ownership to 56% of the fully-diluted equity and 68% of the outstanding shares. Under the new governance scheme in place after the closing of the Series A financing, KV and Sigma were entitled to approval and veto rights for many corporate acts. Nguyen retained just a few protections, including entitlement to a seat on the Board and class vote protection under Section 242(b)(2) of the DGCL requiring the approval of the holders of the majority of common stock for any amendment to View’s certificate of incorporation changing the number of authorized shares, par value or rights and preferences of the company’s common stock. Additionally, Nguyen was to retain certain rights under View’s voting agreement, including the ability to approve changes to the size of the Board and fill a Board seat.

In December 2008, View hired a new CEO who was also granted the right to a Board seat under a newly adopted voting agreement. Following this hiring, View began excluding Nguyen from Board meetings. In January 2009, View removed Nguyen as Chief Technology Officer and, shortly thereafter, terminated his employment completely. Subsequently, he was removed as a member and Chairman of the Board. View seemingly made every effort to separate Nguyen from the company without either a Board or stockholder vote. However, under the operative voting agreement and current

certificate of incorporation of the company, Nguyen remained entitled to a seat on the Board. Nguyen challenged View's actions in terminating him.

Several months later, as the termination dispute remained pending, Sigma and KV caused View to amend its charter to authorize the issuance of convertible notes to Sigma and KV and increase the number of authorized shares of common stock. Nguyen did not consent to these amendments on either occasion, either as a Board member or the majority holder of common stock as required by Section 242(b)(2) of the DGCL.

In the fall of 2009, View sought its stockholders' consent to pursue a Series B preferred stock financing round (the Financing). This time, the company sought Nguyen's consent to the Financing and related documents as part of settlement negotiations relating to the termination dispute. Although Nguyen expressed concerns regarding the Financing, View conditioned the settlement on Nguyen's consent to the Financing, and Nguyen and View ultimately entered into a settlement agreement (the Settlement Agreement), which allowed for rescission by either party within seven days of execution. After a closer review of the Financing transaction documents, Nguyen determined that the restated governance documents would result in a significant diminution of his rights as a stockholder. Among other things, the Financing documents eliminated the class vote right under DGCL Section 242(b)(2), the rights of the common stockholders to elect any Board member and Nguyen's only Board seat along with his position as Chairman. Upon becoming aware of these issues, Nguyen formally rescinded the Settlement Agreement, thereby revoking his consent to the Financing prior to its closing (and within the rescission period). During this period, however, View had already proceeded with closing the Financing as if Nguyen had consented.

In January 2010, Nguyen responded by filing claims against View in California state court. The parties subsequently moved the dispute to binding arbitration. As the arbitration was proceeding, View closed several additional rounds of financing, raising over \$500 million in additional capital. Nguyen sought a declaration that his revocation of consent was valid and that the closing of the Financing was void and invalid, and the arbitrator ruled in his favor. Because each of the subsequent financing rounds rested on the Financing, the invalidation of the Financing effectively "blew up" View's capital structure.

In an attempt to turn back the clock and restore the Financing, View took a series of corrective steps. View's Series A preferred stockholders converted their shares to common stock, displacing Nguyen as majority holder of common stock, thereby rendering his consent unnecessary to effect the Financing and subsequent rounds. The conversion also terminated View's voting agreement. View then filed multiple certificates of correction and certificates of validation with the Secretary of State pursuant to Section 204. In these certificates, View purported to ratify various charter amendments that increased the number of authorized shares and other corporate acts in connection with the Financing and the subsequent financing rounds. Through termination of the voting agreement, View reconstituted its Board and removed Nguyen from the Board. View soon realized that even these steps were taken improperly, and in April 2016, purportedly corrected its prior ratifications. Subsequently, Nguyen filed an amended complaint in which he challenged the certifications of validation under Section 205 and the validity of various corporate acts and transactions related to the financing rounds. View moved to dismiss the complaint.[2]

THE COURT'S ANALYSIS

The Court held that Section 204 was inapplicable because the Financing was not a “defective corporate act” subject to ratification under Section 204. Rather, it was an *unauthorized* corporate act because Nguyen had effectively revoked his consent to the Financing before the transaction had closed.

The Court began its analysis with a discussion of Section 204’s legislative history. The Court explained that the Section was adopted as a “safe harbor procedure” to allow corporations to validate acts that would otherwise be void or voidable. As the legislative synopsis to Section 204 had articulated, the Section was “intended to overturn the holdings in case law . . . that corporate acts or transactions and stock found to be ‘void’ due to failure to comply with the applicable provisions of the [DGCL] or the corporation’s organizational documents may not be ratified or otherwise validated on equitable grounds.” The Section was a legislative response to prior case law that had treated statutory formalities for the issuance of stock as a necessary prerequisite for such stock to be deemed validly issued. This had created a statutory inconsistency between the DGCL and provisions of the Delaware UCC that were designed to validate defective stock in the hands of a purchaser for value. Legislative intervention, therefore, became necessary to resolve the inconsistency and provide a practical solution to allow corporations and their counsel to correct “mistakes made in the context of a corporate act without disproportionately disruptive consequences.”

The heart of the Court’s analysis is in its statutory interpretation exercise. The Court first examined the plain language of Section 204, focusing on the Section’s definitions of “defective corporate act”^[3] and “failure of authorization.”^[4] The Court emphasized that based on the definition of “defective corporate act,” “to be captured within the remedial purposes of the statute,” the ratifications in question must have been directed at acts *that at the time such acts were purportedly taken*, would have been within the power of the corporation but were void or voidable due to a *failure of authorization*. The Court held that at the time View acted, it did not have the power to do so because the majority common stockholder had declined to approve such acts. Moreover, Nguyen’s revocation of consent was more than a mere “failure of authorization”—it was a rejection of a corporate proposal, the “classic exercise of the stockholder franchise to say ‘no’ to a Board-endorsed proposal.” A failure of authorization is distinct from a deliberate “no” vote or outright rejection or refusal of a proposal by the majority of stockholders entitled to vote thereon. The Financing was declared void not due to any failure by View to comply with the law or its governing documents, but rather because the majority common stockholder had deliberately rejected it. To further drive home the distinction between a failure to authorize and a rejection of a corporate proposal, the Court examined the dictionary definitions of “failure” and “rejection” and noted that failure is an omission or deficiency while reject means to refuse to accept or consider.

The Court also emphasized that nothing in the text of the statute or its legislative history suggested the General Assembly had intended to facilitate a corporation’s efforts to ratify acts that stockholders had expressly voted against years prior or certify such acts as effective on the date of the stockholders’ rejection. The Court then rejected View’s argument that because it had the right to convert its Series A preferred stock into common stock prior to the Financing, the Court should view the conversion as if it had occurred at that time (rather than well after the Financing had closed). The Court stated that Section 204 is not a “license to cure just any defect” and cannot be used to retroactively authorize an act that was never taken or to backdate an act that the corporation wishes had occurred as of an earlier date.

Finally, the Court noted that no decision of the Chancery Court or Delaware Supreme Court has ever applied Sections 204 or 205 in a circumstance in which a board of directors sought to use statutory ratification to alter a stockholder vote. Such an interpretation would significantly diminish stockholders' rights. The Delaware courts have "blessed" ratification efforts where the failure of authorization was the product of a board failure to adhere to formalities related to stock issuances, technical dating discrepancies in stockholder consents, improper notices to stockholders, missing records and timing issues or failure to properly seek a required approval from the board or stockholders.

CONCLUSION

This decision provides useful clarification on the limits of Section 204's applicability and highlights an important distinction between acts that are defective due to a failure of authorization, such as where a corporation inadvertently fails to comply with its governing documents or the DGCL, and those that are deliberately rejected by the stockholders entitled to vote thereon. Corporations should take note that Section 204 does not grant a broad license to cure all conceivable defects or work around necessary stockholder approvals to board-recommended transactions.

If you have questions or would like additional information, please contact Lori Smith (smithl@whiteandwilliams.com; 212.714.3075), Bridget Henwood (henwoodb@whiteandwilliams.com; 212.631.4421) or another member of our Corporate and Securities Group.

[1] Section 204 generally provides that "no defective corporate act or putative stock shall be void or voidable solely as a result of a failure of authorization if ratified as provided in this section or validated by the Court of Chancery in a proceeding brought under § 205 of this title." It also sets forth the requirements and procedures for ratifying defective corporate acts.

[2] The Court noted that, in articulating their positions, the parties relied on Section 205 (which allows parties to petition the Chancery Court to determine the effectiveness and validity of any corporate act, including defective corporate acts ratified pursuant to Section 204). However, the Court focused on Section 204, explaining that the parties' dispute actually raised the issue of whether View's attempted ratification comported with Section 204.

[3] Section 204 defines "defective corporate acts" 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 under subchapter II of this chapter, but is void or voidable due to a failure of authorization."

[4] Section 204 defines "failure of authorization" as: "(i) the failure to authorize or effect an act or transaction in compliance with the provisions of this title, the certificate of incorporation or bylaws of the corporation, or any plan or agreement to which the corporation is a party, if and to the extent such failure would render such act or transaction void or voidable; or (ii) the failure of the board of directors or any officer of the corporation to authorize or approve any act or transaction taken by or on behalf of the corporation that would have required for its due authorization the approval of the board of directors or such officer."

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