

Mistakes were made: corporate cleanups

By *Evan Youngstrom*

Founders and entrepreneurs wear many hats in a startup, one of which is Chief Paperwork Officer. Although that is a glorious position, when you are focusing energy on building the business, ensuring all of the corporate governance and legal paperwork is in good order usually moves to the backburner.

Luckily, in 2014, Delaware enacted Section 204 of the General Corporation Law to help corporations (big and small, public and private) fix prior defective corporate acts. Prior to 2014, Delaware corporations could not ratify such acts because of stringent case law. Section 204 is critical for early-stage companies because they often need to clean up their corporate history prior to a financing or an acquisition.

Section 204 is essentially a playbook for a company's board of directors and stockholders, showing them how to fix prior defective corporate acts that would otherwise be void or voidable under Delaware law. For example, if a CEO issues shares to a new employee without proper approval from the board of directors, the board of directors can retroactively ratify that issuance. In addition, Section 204 can ratify the appointment of a director who was not properly appointed and can ratify the proper actions that the unauthorized director made.

However, Section 204 cannot be used to change history. If the CEO had not originally issued shares, the board of directors cannot go back in time and issue the shares to that employee at a prior date. In addition, Section 204 cannot be used to ratify a corporate act that was rejected by a previous iteration of the board of directors or stockholders.

Simply put, to invoke Section 204 to cleanse the past, the company must ensure the following actions are properly completed.

1. The current board of directors will need to approve and adopt resolutions that describe the details of the prior defective corporate act (eg, date, number and type of shares, nature of the reason for needing ratification).
2. If the prior defective corporate act required stockholder approval at the time of such act, then the company's current stockholders will need to pass resolutions approving and ratifying such prior defective corporate act. In addition, the company will need to send notices (which need to include a copy of the board of directors' resolutions) to the company's current stockholders and former stockholders, who were holders of valid stock or putative stock at the time of such act.
3. If the prior defective corporate act required a filing with the State of Delaware, then the company will need to file a certificate of validation.

Cleaning up prior defective corporate acts usually occurs during a financing or acquisition because that is when the lawyers are checking the paperwork. However, the cleanup process can cost thousands of dollars and take weeks or months, which would likely delay the financing or acquisition. For example, the filing fee (which does not include lawyers' fees) for the certificate of validation is approximately \$2,500 and cannot be expedited, like other Delaware filings.

In sum, it is best not to wait for a financing or acquisition to clean up the past; when you have identified a defect, clean it up right away. Section 204 is one of the many tools that we can use to help companies move past missteps by the Chief Paperwork Officer and move ahead to the next milestone.



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