

# ORANGE COUNTY BUSINESS JOURNAL

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### Pitfalls of Delaware Corporate Law

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In order to create the invaluable certainty that Delaware corporate law provides to boards of directors and stockholders with respect to corporate governance and capital structure, the General Corporation Law of the State of Delaware (the "DGCL"), and court decisions interpreting the DGCL, provide strict technical requirements that a board of directors and stockholders must follow when seeking to take certain actions.

The strict technical requirements create many pitfalls for a business owner who has incorporated a business in Delaware and the board of directors of that business. These pitfalls generally remain unknown until litigation arises or due diligence on the corporation is performed in connection with an important transaction. The business owner and board of directors then may discover that certain actions taken were invalid, which could have the effect, for example, of voiding stock that a person believed he or she owned. The following pitfalls are some of the most common:

#### Written Consents of Stockholders

Unless the right is eliminated in the certificate of incorporation, stockholders have the right to take action by written consent instead of at a meeting of stockholders. Although the right to act by written consent promotes efficiency, if the written consent is not dated properly or does not include exhibits referred to in the consent, then the consent likely is invalid.

A written consent of stockholders often is drafted with a date at the top of the first page. The date is meant to represent the effective date of the written consent. However, a consent with only a date at the top of the first page is not valid under Delaware law. Each stockholder must separately date the consent, preferably by hand.

In addition, a written consent of stockholders often refers to forms of agreements or other documents being approved that are attached as exhibits. It is common practice for stockholders to execute the written consent without having

the exhibits at the time of execution and to attach the exhibits afterwards. This practice does not comply with the requirements of Delaware law and will render the written consent invalid.

The DGCL, which requires that every written consent "bear the date of signature of each stockholder" who signs the consent and every consent be delivered to the corporation "within 60 days of the earliest dated consent," is the source of the technical requirement that written consents of stockholders be dated by hand. Although the DGCL does not specifically have a handwriting requirement, Delaware courts have questioned the validity of individual pre-printed dates on written consents.

Similarly, the DGCL requires that any action taken pursuant to a written consent of stockholders be set forth in the consent. The Delaware courts have concluded that where a written consent refers to an exhibit, the stockholder must have the exhibit to execute a valid consent.

Best practice suggests that stockholders of a Delaware corporation should follow closely the formalities required by Delaware law when executing a written consent by individually hand-dating the consent and being in possession of all exhibits referred to in the consent.

#### Stock Issuances

Issuing stock may be the most important action taken in a corporation's existence because ownership of stock (including the related economic benefits) generally is the reason for organizing a corporation. Delaware law requires strict adherence to certain formalities when issuing stock to ensure certainty in the corporation's capital structure. Nevertheless, shares of stock often are issued without consideration of the DGCL's formalities. It is common to see evidence of a stock issuance on an electronic capitalization table, which, at times, refers only to percentage ownership interests in, and not the number of shares owned of, the corporation.

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The DGCL requires that the board of directors of a corporation authorize the issuance of stock. Delaware courts have interpreted this requirement to mean that a written instrument evidencing board approval is necessary to issue shares of stock. The failure to approve the stock issuance in writing renders the issued stock void. Evidence of stock ownership in the form of spreadsheets, accounting statements or tax filings is insufficient to overcome the lack of board approval in a written instrument.

Best practices in connection with the issuance of shares of stock are to approve resolutions at a meeting of the board of directors or by written consent specifying the number of shares of stock being issued and the consideration being paid for the shares.

## Amendment to Certificate of Incorporation

The most common substantive reasons for amending a corporation's certificate of incorporation are to permit a change to the corporation's capital structure or the stockholders' relative rights and preferences. In most cases, the amendment impacts a fundamental reason for owning shares of stock in the corporation. Notwithstanding the nature of an amendment to a corporation's certificate of incorporation, many boards of directors and stockholders do not consider the ramifications of a misstep in connection with the amendment. As a result, the DGCL's formalities get overlooked, which unnecessarily increases risk of expensive litigation down the road.

The DGCL requires that the board of directors adopt resolutions that state the proposed amendment to the certificate of incorporation, declare that the amendment is advisable and direct that the amendment be proposed to the stockholders. The stockholders then must determine whether to approve the proposed amendment. On numerous occasions, the Delaware courts have made clear that under no circumstance may a proposed amendment be approved only by stockholders or by stockholders before the board of directors adopts resolutions approving the amendment. Delaware courts will look past the effective date of the resolutions to determine the order in which the resolutions were approved or the consents signed by, for example, reviewing emails containing signature pages of both the board of directors' written consent and the stockholders' written consent. In addition, the stockholders must approve the exact language of the amendment to the certificate of incorporation that the board proposed. The failure to satisfy

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these strict requirements will result in an invalid amendment to the certificate of incorporation.

Best practice in connection with amending a certificate of incorporation is for the board of directors to adopt the proposed language and declare it advisable at a meeting or by written consent, and then for the stockholders to approve the exact proposed amendment at a meeting or by written consent.

## Conclusion

The pitfalls discussed above appear innocuous but satisfying the technical requirements of Delaware corporate law is crucial to avoid creating unnecessary risk down the road. Recent amendments to the DGCL permit Delaware corporations to validate most corporate acts taken in violation of the DGCL (including any issuance of stock in excess of the number of authorized shares of stock, any election of directors and any other act that is permitted to be taken under the DGCL). However, the significant legal expenses, costs to file necessary documents with the Secretary of State of the State of Delaware, distraction from business operations, difficulty to reach former stockholders and risk of delaying an important transaction, make it highly undesirable to rely on these procedures. The better approach is to comply in the first instance with the technical requirements of the DGCL.