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### Fixing the Unfixable Cap Table

by Marc Boiron, Attorney, Rutan & Tucker, LLP

Unfortunately, being a startup is hard. Startups are cash strapped but need advice. Most of them forgo legal advice because of the high cost of obtaining good advice, which is completely understandable. However, once the average startup becomes a high-growth startup or needs capital to reach high-growth startup "status," it needs to deal with the issues that resulted from the lack of good legal advice. Often times, the cap table has suffered the most.

Many startups with grand aspirations hear through the grapevine that incorporating in Delaware is the right choice. That is generally true but, until a few years ago, many of the capitalization problems of a Delaware incorporated startup could not be fixed without monumental efforts that may be unsuccessful.

A common issue that arises with startup companies is that they find out shares previously issued had not been properly issued to some or all of their stockholders who hold "bad" stock. The company often discovers the problem in connection with an equity financing, which is when it brings in reputable legal counsel for the first time.

Many startups and lawyers then try to fix the problem by having the board and stockholders ratify the improperly issued shares without knowing that Delaware case law does not permit that ratification. Therefore, the problems are exacerbated.

Historically, the only correct way to solve the problem was to track down every person who had ever owned stock of the company and have them agree that all of the actual stockholders were exchanging their "good" and "bad" shares for "good" shares and all other stockholders were agreeing that they did not have any rights in the stock of the company. On the eve of an equity financing it was the last thing management wanted to handle.

Fortunately, the Delaware corporate statute was amended several years ago to give startups a way to fix issues, including cap table issues that Delaware courts previously had determined could not be fixed. Although widely used, most startups (and, unfortunately, many attorneys representing startups), have never heard of or forget about Section 204 of the Delaware General Corporation Law.

Although Section 204 is a complicated statute with many nuances, at a high level, it permits a company to fix problems by ratifying prior acts using the following steps:

1. The board of directors must ratify the "defective corporate act" with specific details in the ratification regarding that act and nature of the issues created by the act. In layman terms, a defective corporate act is the thing that was done wrong (such as, issuing shares that were not authorized, improperly electing directors, or approving another action without properly authorizing it).
2. If the stockholders would have needed to approve the defective corporate act when it was originally taken incorrectly, then the stockholders also must ratify the defective corporate act. Only the stockholders that own valid stock (i.e., stock that is known to have been properly issued) are entitled to approve the ratification. A notice would need to be sent to all of the stockholders if the ratification were done at a meeting, but most startups will act by written consent. If the ratification occurs by written consent, then a notice that stockholders approved the defective

corporate act needs to be given to all of the stockholders – those holding "good" and "bad" stock – and they need to be informed of their right to ask the Delaware Court of Chancery to declare the ratification invalid.

3. If the stockholders would not have needed to approve the defective corporate act when it was originally taken incorrectly, then no stockholder approval is needed to ratify the act but notice of the ratification of the defective corporate act by the board of directors still needs to be given to all of the stockholders – those holding "good" and "bad" stock – and they need to be informed of their right to ask the Delaware Court of Chancery to declare the ratification invalid.

4. If the defective corporate act would have required a filing with the Delaware Secretary of State when it was originally taken incorrectly, then the company would need to file what is referred to as a "certificate of validation." The certificate of validation must provide a detailed recital of, among other things, each defective corporate act and the nature of the issue created by the act. A separate certificate of validation needs to be filed for each defective corporate act that would have required a filing at the time of the original act. The minimum filing fee for each certificate of validation is a whopping \$2,500. In a recent Delaware case, the court noted that a company had filed 22 certificates of validation, which cost that company at least \$55,000.

Section 204 has a broad application. It has been used to ratify (i) a board's failure to follow corporate formalities when authorizing a stock issuance, (ii) technical dating discrepancies in stockholder consents, (iii) improper notice to stockholders, (iv) various missing records issues, timing issues, authority issues, and validity of board and stock issues, and (v) a failure properly to seek the required approval from either a board of director or stockholders.

However, it also has limitations. Among other limitations, a recent case decided in Delaware has made clear that the procedures set out above cannot be used to overturn an action taken in the past. If stockholders previously rejected a proposed corporate act, Section 204 cannot be used to retroactively overturn that act.

The best part about a ratification under Section 204 is that it works retroactively so that all other corporate acts taken after the incorrect act in reliance on that original act having been properly taken are fixed as well. That being said, just because the ability to fix mistakes exists, it does not mean companies should rely on it. The process can get complicated and result in significant legal costs and filing fees, but it gives startups a way out from their early mistakes and a way to fix what used to be an unfixable cap table.

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