Akin Gump STRAUSS HAUER & FELD LLP

Corporate Alert

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2013 Changes to Delaware Corporate and LLC Law

In this alert we summarize the most important recent additions and amendments to the Delaware General Corporation Law (the "DGCL") and the Delaware Limited Liability Company Act (the "DLLCA"). These changes include:

- permitting the directors of a corporation to establish consideration for the issuance of capital stock pursuant to a formula (Section 152);
- allowing a corporation to ratify void or voidable corporate acts and providing for the ability for the Delaware Court of Chancery to review those ratifications (Sections 204 and 205);
- under certain conditions, eliminating a stockholder vote in a two-step merger even when the acquiror holds less than 90% of the target corporation's shares (Section 251(h));
- deterring the use of so-called "shelf" corporations (Sections 312(b) and 502(a));
- creating a new type of Delaware entity, the Public Benefit Corporation, the directors of which are permitted to consider public welfare in addition to stockholder value (Sections 361 to 368); and
- clarifying that a default fiduciary duty exists (though waivable) for limited liability companies (Section 18-1104).

These changes took effect on August 1, 2013, except for the provisions allowing the ratification of defective corporate acts, which will take effect on April 1, 2014.

Delaware General Corporation Law

Stock Issuance Consideration (Section 152; Effective August 1, 2013)

Section 152 of the DGCL was amended to allow a board of directors to approve a formula to establish the consideration received by a corporation for the issuance of capital stock; for example, this formula could refer to the market price of the corporation's stock over a period of time.

Ratification of Defective Corporate Acts (Sections 204 and 205; Effective April 1, 2014)

A new section of the DGCL, Section 204, provides corporations with the opportunity to ratify certain corporate actions that would otherwise be void or voidable. Previous case law had held that corporate transactions that were void or voidable because of their failure to comply with the corporation's organizational documents or statutory law could not subsequently be ratified. See, e.g., *STAAR Surgical Co. v. Waggoner*, 588 A.2d 1130 (Del. 1991) and *Blades v. Wisehart*, 2010 WL 4638603 (Del. Ch. Nov. 17, 2010). For instance, if a corporation issued more shares than authorized by its charter, it could not ratify that issuance subsequently but would instead be required to amend its organizational documents to permit the issuance and then re-issue the shares. Beginning April 1, 2014, Section 204 will address this issue by providing corporations with a "safe harbor" to ratify defective corporate acts.

Corporations wishing to ratify a void or voidable action must adopt a resolution setting forth the defective act, the time it was taken and, if the defective corporate act involves the issuance of shares, the number and type of shares that were to have been issued. The resolution must also state the reason the act was invalid (e.g., the issuance exceeded the number of authorized shares) and that the board ratifies such action. If the defective act required stockholder approval, or if stockholder approval is required at the time the resolution is made, stockholders must ratify the defective act at a meeting with at least 20 days' prior notice. Regardless of whether stockholder approval is required, stockholders must receive written notice of the board resolution within 60 days of the adoption of such resolution.

Beginning April 1, 2014, the newly adopted Section 205 of the DGCL vests the Court of Chancery with exclusive jurisdiction over any action brought in respect of defective corporate acts. Such action may be brought by the corporation, any successor entity, any director, any record or beneficial holder of valid or putative stock (whether at the time of the action or the time of the defective corporate act) or any other person claiming to be substantially and adversely affected by a ratification pursuant to Section 204. Section 205 gives the Court of Chancery the right to determine the validity and effectiveness of (a) any defective corporate act or issuance of stock, rights or options, regardless of whether they were ratified pursuant to Section 204 and (b) the ratification of such defective acts under Section 204. It also gives the Court of Chancery the ability to modify any procedure required under Section 204. In connection with those powers, the Court of Chancery may (a) declare a ratification under Section 204 to not be effective, or to be effective only upon the fulfilling of certain conditions, (b) validate any defective corporate act, including subject to the fulfilling of certain conditions, (c) require measures to remedy any harm to any person affected by a ratification, (d) order the Secretary of State of Delaware to accept filings, including retroactively, (e) order the corporation's stockholders to hold a meeting and exercise the Court of Chancery's powers under Section 227 of the DGCL, and (f) make such other orders as it deems proper, including approving stock ledgers and declaring stock issuances valid.

In making a determination under Section 205, the Court of Chancery may consider (i) whether the defective act was approved with the belief that such approval was in compliance with statutory law and the corporation's organizational documents, (ii) whether the corporation has treated the defective action as valid and whether any person has relied on such action, (iii) whether any harm would result from the ratification of, or failure to ratify, the defective act, excluding any harm that would have resulted if the defective corporate act had been valid when approved, and (iv) any other factor or consideration the Court of Chancery deems just and equitable.

After a period of 120 days following the ratification becoming effective, no claim may be brought on the basis of the defective act being void or seeking to have the Court of Chancery declare the ratification ineffective, unless such claim asserts that ratification was not effected properly under Section 204 or is brought by a person claiming they did not receive notice they were entitled to under Section 204.

Elimination of Stockholder Vote in Some Two-Step Mergers (Section 251(h); Effective August 1, 2013)

Delaware "two-step" mergers are tender or exchange offers, which are typically followed by a "back end" merger (upon closing of the initial offer) in which the non-tendering shares are converted by merger into the consideration paid in the tender or exchange offer. These mergers require a stockholder vote, even if the acquiror, following the consummation of the initial offer, holds the number of shares necessary to approve the merger. If the acquiror held at least 90% of the target corporation's shares, a "short-form" merger, in which a stockholder vote was not required, could be effected. Acquirors could also receive a "top-up" of shares from the target to put them over the 90% threshold and negate the need for a stockholder vote, but this option was not available when the target corporation's authorized but unissued shares were below the necessary number to 'top-up' above 90%. This requirement could lead to a costly delay for acquirors despite the vote being a mathematical certainty. In addition to preparing proxy materials for the stockholder vote, the acquiror could face financing difficulties if the acquiror's lender requires the acquiror to hold all of the target's shares prior to funding any acquisition financing.

The newly added Section 251(h) permits an acquiror to avoid the stockholder vote, even absent a top-up, if pursuant to a merger agreement entered into on or after August 1, 2013:

(i) the target corporation is public (i.e., its shares are listed on a national exchange or held of record by more than 2,000 holders);

(ii) following the consummation of the offer, the acquiror holds at least the number of shares that would otherwise be required to consummate the 'back-end' merger;

(iii) the offer is for any and all of the target corporation's shares;

(iv) no "interested stockholder" (i.e., the holder of 15% or more of the target corporation's shares) is party to the merger agreement;

(v) the offeror under the tender or exchange offer is also the entity that is merged with or into the target corporation; and

(vi) the stockholders who are "squeezed out" receive the same consideration as the tendering, or exchanging, stockholders did in the offer.

Delaware has made conforming changes to (i) the appraisal statute (Section 262 of the DGCL), to clarify that appraisal rights may be applicable in 251(h) mergers, and (ii) Section 252 of the DGCL, to clarify that 251(h) applies to mergers between Delaware and non-Delaware corporations.

Section 251(h) will only apply if the merger agreement explicitly provides so. Further, this provision is only available to corporations, not to limited liability companies or other legal entities. When Section 251(h) is applicable, however, it may save acquirors considerable effort, time and expense.

Since this law went into effect on August 1, 2013, a number of buyers have utilized Section 251(h), including Paulson & Co., represented by Akin Gump Strauss Hauer & Feld, LLP, in its $512 million acquisition of piano manufacturer Steinway Musical Instruments Inc. The Steinway transaction was one of the first to employ Section 251(h), with the parties entering into a merger agreement on August 14, 2013 and closing on September 19, 2013.

Limitations on "Shelf" Corporations (Sections 312(b) and 502(a); Effective August 1, 2013)

The Delaware legislature approved certain amendments to deter the use of "shelf" corporations (i.e., corporations with no stockholders or directors that may be used in the future) by limiting the power of the incorporator. Section 312(b) of the DGCL was amended so that only a corporation's stockholder or director may authorize the extension, restoration, renewal or revival of a corporation that is not in good standing.

Further, Section 502(a) of the DGCL was amended so that a corporation's franchise tax report must (i) be signed by an officer or director of such corporation, except an incorporator may sign an initial report prior to the election of a board of directors, and (ii) list at least one director unless such report is (A) an initial report prior to the election of a board of directors, or (B) filed in connection with such corporation's dissolution.

Public Benefit Corporations (Sections 361- 368; Effective August 1, 2013)

Delaware added a potentially important new subchapter to the DGCL (Subchapter XV), allowing corporations to elect to be formed as, or convert to, a public benefit corporation ("PBC").

Traditionally, directors of corporations have had a fiduciary duty to maximize stockholder value in making decisions. However, PBCs, or social purpose corporations as they are known in some jurisdictions, permit a corporation's directors to also take into account the social purposes of their actions. PBCs began in the 1980s as an anti-takeover instrument. PBCs are typically required to pursue a general public benefit and make available to the public an annual report measuring their performance in meeting their social goals.

Delaware's PBC statute differs from the traditional model in certain key aspects. Delaware PBCs are required to state a specific public benefit, which means "*a positive effect (or reduction of negative effects) on one or more categories of persons, entities, communities or interests (other than stockholders in their capacities as stockholders) including, but not limited to, effects of an artistic, charitable, cultural, economic, educational, environmental, literary, medical, religious, scientific or technological nature.*" Such specific benefit must be identified in the charter of the entity. A PBC's name must include the words "public benefit corporation" or the designation "PBC" or "P.B.C." Stockholder notices and stock certificates, if any, must also clearly identify the entity's PBC status.

Subject to the above requirements, Delaware corporations may be formed as, or convert to, PBCs. Prior to converting, established Delaware corporations must obtain the approval of at least 90% of the outstanding shares of each class of stock of such corporation, whether voting or nonvoting. However, PBCs need only a 66 2/3% vote to terminate their status.

Unlike the public annual reports typically required of PBCs outside Delaware, a Delaware PBC must provide only its stockholders with a statement regarding the progress of its social goals at least once every two years. PBCs may elect to use a third party standard or certification to address how they have met their goals, instead of the mandatory third party certification in other jurisdictions.

Directors of a PBC have a duty to balance the pecuniary interests of the stockholders, the best interests of those materially affected by the PBC's conduct and the specific public benefit identified in the PBC's charter. Delaware addressed the potential liability regarding these duties by allowing only stockholders holding at least 2% of the PBC's shares or, if a corporation is publicly traded, at least $2,000,000 in market value, to maintain a derivative lawsuit for breach of such duties. A director is deemed to have met his or her fiduciary duties if the director acted in a manner that is "informed and disinterested and not such that no person of ordinary, sound judgment would approve." In addition, the PBC charter may include a provision that any disinterested failure by a director to satisfy such duties does not constitute a breach of the duty of loyalty and will be presumed to be in good faith.

Case law regarding PBCs is limited. This is because the constituencies that benefit from PBC statutes typically lack standing to enforce them, as in Delaware. In addition, directors have an assortment of anti-takeover mechanisms to choose from, thus lessening the frequency of PBCs and the litigation surrounding them. While there is no uniform jurisprudence, one case suggests that a company facing a tender offer may not use as a pretext considerations of a company's employees, customers and community for a "just say no" approach that would otherwise be unreasonable under the Unocal rule. See *Amanda Acquisition Corp. v. Universal Foods Corp.*, 877 F.2d 496 (7th Cir. 1989). Another case concluded that a company may consider the needs of its employees, customers and suppliers, in addition to its stockholders, in determining the timing of a stockholder referendum on whether to accept a tender offer and redeem a poison pill. See *Georgia-Pacific Corp. v. Great Northern Nekoosa Corp.*, 727 F. Supp. 31 (D. Me. 1989). Other cases have suggested that considerations of maximizing stockholder value still hold primacy, even when they are not the exclusive consideration. See *Hilton Hotels Inc. v. ITT Corp*, 978 F. Supp. 1342 (D. Nev. 1997); *Baron v. Strawbridge & Clothier*, 646 F. Supp. 690 (E.D. Pa. 1986). These scattered cases consider a general effect on employees, customers, suppliers and/or the community and therefore may have limited applicability in Delaware, where the PBC statute requires a specific public benefit to be identified.

PBC status is attractive to corporations wishing to pursue social good while also seeking profit for their stockholders. Entities without a clearly defined social benefit may not be interested in PBC status. In addition, publicly traded entities, even those with identifiable benefits to the public, may find the 90% stockholder approval threshold in Delaware too high a bar. However, private corporations that see social good as being complementary to, rather than at odds with, stockholder maximization may find PBC status an attractive option.

Delaware Limited Liability Company Act

Default Fiduciary Duty (Section 18-1104; Effective August 1, 2013)

Prompted by the Delaware Supreme Court's decision in *Gatz Properties, LLC v. Auriga Capital Corp.*, 59 A.3d 1206 (Del 2012), "to resolve any statutory ambiguity" as to whether the DLLCA imposes default fiduciary duties, the Delaware legislature amended Section 18-1104 of the DLLCA to clarify that fiduciary duties govern the internal affairs of limited liability companies if the limited liability company operating agreement is silent on the matter. Parties to a limited liability company operating agreement, may, however, expressly provide for a waiver of fiduciary duties or limit the scope of such duties with respect to members and/or managers. In many cases, even if LLC members may not want the full panoply of fiduciary duties, there may be a desire for:

(i) duties of loyalty (i.e., members and managers put the interests of the business above other competing interests),

(ii) duties of candor (i.e., sharing in sufficient detail information necessary to make an investment or voting decision), and/or

(iii) duties of care (i.e., the people who are granted the authority to manage the operations of the business do so based upon a prudent business standard).

The assumption, as codified by the recent amendment, is that all of these duties and more are embedded on a default basis in the limited liability company relationship among members and their management team. Removing the protections in one fell swoop may not be prudent. A better course of action may be to identify thoughtfully and expressly waive those categories of protections that are not needed and retain the others by default.

Contact Information

If you have any questions regarding this alert, please contact:

Kerry E. Berchem
kberchem@akingump.com
212.872.1095
New York

Terry Enright
tenright@akingump.com
212.872.8022
New York

Ackneil M. Muldrow III
tmuldrow@akingump.com
212.872.1064
New York

Patrick J. Dooley
pdooley@akingump.com
212.872.1080
New York

Daniel I. Fisher
dfisher@akingump.com
202.887.4121
Washington, D.C.

C.N. Franklin Reddick III
freddick@akingump.com
310.728.3204
Los Angeles – Century City

David Patrick Elder
delder@akingump.com
713.220.5881
Houston

C. Steven Kahn
skahn@akingump.com
212.872.8092
New York

Thomas H. Yang
tyang@akingump.com
214.969.2720
Dallas

