

Date of Hearing: June 29, 2021

ASSEMBLY COMMITTEE ON BANKING AND FINANCE

Timothy Grayson, Chair

SB 218 (Jones) – As Amended June 7, 2021

SENATE VOTE: 38-0

SUBJECT: Corporations: ratification or validation of noncompliant corporate actions

SUMMARY: Creates two mechanisms for a California corporation to ratify or validate an otherwise-lawful corporate act that was not in compliance with General Corporation Law or the corporation's articles or bylaws when that act occurred. Specifically, **this bill:**

- 1) Allows for otherwise lawful corporate actions not in compliance, or purportedly not in compliance, with General Corporation Law, or a plan or agreement to which the corporation is a party in effect at the time of the corporate action, to be ratified or validated by the superior court.
- 2) Requires ratification of a corporate action to be approved by a corporation's board of directors and, if applicable, by the shareholders or outstanding shares of the corporation in accordance with the General Corporation Law or the articles or bylaws in effect at the time of the ratification. If a higher approval standard was needed for the original corporate action, then the ratification must be approved in accordance with the higher approval standard.
- 3) Provides that, upon the filing of a civil action in superior court by a corporation, any successor entity to that corporation, any director or shareholder of that corporation, or any other person claiming to be substantially and adversely affected by the ratification of a corporate action pursuant to the procedure added by this bill, a superior court may determine the validity of the ratification. The superior court may also make orders as to any and all matters concerning a ratification, as necessary to ensure justice and equity, but provides that the court may not validate an action that is otherwise prohibited or alter the effective date of any filing with the Secretary of State (SOS).
- 4) Prohibits the ratification or validation of a corporate action and renders it void if, by virtue of the ratification or validation, an instrument previously filed with SOS or provision within an instrument previously filed with SOS would become incorrect or incomplete.

EXISTING LAW:

- 1) Provides for the General Corporation Law (Division 1 of Title 1 of the Corporations Code; Section 100 et seq.), which prescribes rules governing domestic and foreign corporations authorized to do business in California.
- 2) Provides a mechanism by which a corporation may correct any agreement, certificate, or other instrument relating to that corporation with respect to any misstatement of fact, any defect in the execution of that document, or any other error or defect contained in that document, but provides that no certificate of correction may alter the wording of any resolution or written consent adopted by the board of directors or the shareholders of that corporation or effect a corrected amendment of the corporation's articles, when such

correction would not have complied with the requirements of the General Corporation Law at the time of filing of the agreement, certificate, or other instrument being corrected (Corporations Code Section 109).

FISCAL EFFECT: Unknown. This bill is keyed fiscal by Legislative Counsel.

COMMENTS:

1) **Purpose.**

According to the author:

Current law does not allow a pathway to correct otherwise lawful corporate actions that failed to comply (or purportedly failed to comply) with legal procedures when originally undertaken. This uncertainty negatively affects the ability of California corporations to raise money, complete mergers, acquisitions, and sales, and undertake other significant transactions. SB 218 creates a statutory mechanism to allow corporations to ratify (or petition the superior court to validate) noncompliant but otherwise lawful corporate actions, providing greater certainty to California businesses.

2) **Background.**

In recent years, a number of states have enacted laws allowing for new processes to correct a prior corporate action that violated certain state corporations laws or the company's bylaws. An example of such a corporate action is when a company issues unauthorized shares of its stocks to investors, which renders that stock issuance, along with the votes of those stockholders, as invalid. This invalidity can lead to significant negative consequences for the company in later years. These improper corporate actions are typically performed inadvertently by an early stage company or a smaller business with limited legal resources. Supporters note that the uncertainty around how to correct corporate actions can have significant implications for the ability of corporations to raise money and complete mergers, acquisitions, and sales.

In 2013, Delaware was the first state to pass a law allowing a corporation to correct a corporate action through ratification (also sometimes called a "self-help" process) or through validation by the courts. Since the enactment of the Delaware statute, a number of other states – including Nevada, Washington, and Texas – have enacted legislation providing processes for corporations to correct these prior actions. Like the Delaware statute, this correction can be done either through corporate ratification (which involves the board or shareholders approving that prior action) or through judicial validation (which allows a key stakeholder to petition a court to validate the prior action).

3) **How these mechanisms work.**

This bill allows for these two processes that can be used to correct prior corporate actions, and they work as follows:

- a) **Corporate ratification.** Under the ratification process, the board of directors adopts a resolution and votes to ratify the action. If that action initially required shareholder

approval, then the shareholders who would have originally voted on the action under the bylaws at the time must also vote to approve the ratification. As the sponsor notes, this helps ensure that this ratification occurs in as similar a way as possible to the original vote. Moreover, if that corporate action was subject to a higher approval standard, such as a supermajority vote, then the ratification must also meet that standard.

One exception to this process is the appointment of the initial directors of the company. As noted by Senate Judiciary Committee's analysis of this bill, an improperly appointment initial board of directors can become an existential problem for a company because every decision made by that board can be deemed invalid. This bill instead allows the current board of directors to approve the ratification by adopting a resolution setting forth the names of the intended initial directors and their putative appointment dates, and stating that the ratification of the initial directors is approved.

- b) **Court validation.** This bill's superior court validation procedure is an alternative to the corporate ratification procedure (or a follow-up to it in case of a failure to ratify) and allows the corporation, any director or any shareholder or putative shareholder to petition the superior court for an order determining the validity of any corporate action. The court with jurisdiction in equity may decide to validate the action or decline to do so.

4) **How about some real world examples?**

As noted above, Delaware was the first state to enact this type of legislation, and this bill's sponsors have provided the committee with examples of cases resolved under the Delaware law. For example, the company Design Within Reach at one time intended to effect a 50-to-1 reverse stock split (meaning a shareholder would now hold one share for every 50 shares initially held), but the company inadvertently provided for a 2500-to-1 reverse stock split instead. This error was discovered only later following an attempted acquisition of the company and related litigation. That case was resolved in large part through Delaware's new ratification process.¹

In another case, a company named CertiSign Holdings discovered, upon exploring a potential sale of the company, that a stock issuance years prior had been improperly approved. Because of unrelated internal strife between directors, the board could not come to an agreement to ratify this action. Instead, the company petitioned the court for a judicial order ratifying the defective corporate acts related to the issuance of the invalid stock.²

5) **Arguments in support.**

The Corporations Committee of the Business Law Section of the California Lawyers Association is the sponsor of SB 218 and writes that

It is not unusual for small, privately held corporations (often family-owned at the start) to be managed with less formality than seasoned corporations. Such

¹ See <https://www.lit-ma.shearman.com/Delaware-Court-Of-Chancery-Validates-Ratification> for additional discussion of this case.

² <https://courts.delaware.gov/Opinions/Download.aspx?id=274090>

businesses often try to conserve resources by, among other things, handling management procedures on their own rather than seeking the advice of legal experts. In the nature of things, and as the individuals who form California corporations often hope, these businesses can develop to a stage where the formality of board and shareholder actions becomes more important. That often happens when developing businesses reach the point of undertaking significant corporate transactions, such as seeking outside funding, acquiring other businesses, selling a line of business (or the entire corporation), or undertaking an initial public offering. When corporations reach that point, management often learns that certain prior corporate actions were not properly undertaken and that corrective action is necessary to proceed with the transaction.

6) Arguments in opposition.

None received.

REGISTERED SUPPORT / OPPOSITION:

Support

California Lawyers Association (Sponsor)

California Lawyers Association, Business Law Section (Sponsor)

Southwest California Legislative Council

Opposition

None on file.

Analysis Prepared by: Luke Reidenbach / B. & F. / (916) 319-3081