ANNUAL REPORTS COMING TO PENNSYLVANIA AND OTHER UPDATES TO THE PENNSYLVANIA ASSOCIATIONS CODE: PART 4—RATIFYING DEFECTIVE ACTIONS

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U.S. Corporate Alert

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On 3 November 2022, Governor Wolf signed House Bill 2057 into law as Act 122. The act made numerous amendments to Title 15 of the Pennsylvania Consolidated Statutes, also known as the "Associations Code" (the Title 15 Update).[1] This multipart series provides a summary of the key changes coming to Pennsylvania entities through the Title 15 Update. Part 1 provided a high-level summary of the key changes. Part 2 discussed the annual report requirements. Part 3 discussed, among other things, the changes relating to the business judgment rule, renunciation of business opportunities, and forum selection. This Part 4, the final part, discusses the new statutory method for ratification of defective entity actions. The Title 15 Update went into effect on 2 January 2023,[2] with certain provisions going into effect at a later date.[3]

SUMMARY

The Title 15 Update adds statutory procedures to ratify defective actions by Pennsylvania entities. Ratifications under the Title 15 Update require action by the board, or other applicable governing body, of the entity. Approval by the interest holders of the entity will also be mandatory where such approval is required by Title 15, any agreement, governing document, or other applicable rule. If the defective act required a filing, the entity must also make a validation filing with the Pennsylvania Department of State.[4]

RATIFICATION OF DEFECTIVE ACTIONS; STATUTE OF REPOSE

The Title 15 Update establishes statutory procedures[5] for correcting mistakes made by entities in their governance relating to authorization of entity action, with retroactive effectiveness to most defective actions occurring prior to the Title 15 Update. The availability of the statutory procedures does not preclude the use of common-law ratification, if available.[6]

In general, ratification of defective acts under the new statute will require approval by the classes of parties that should have originally approved the action. The quorum and voting requirements for such approvals, for both governing bodies and interest holders, are those in effect on the date that the ratifying approval is sought. Those holding interests that were purportedly created or issued as a result of a defective entity action (putative interests) are not entitled to vote those putative interests (which also do not count for quorum purposes), except in some

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circumstances involving the most “registered” (in general, publicly traded) corporations. After validation, such putative interests are considered issued as of the time of their purported issuance.[7]

Where a ratified action would have required a filing with the Pennsylvania Department of State, the entity must submit a statement of validation to the Pennsylvania Department of State, which must include (a) the name of the entity; (b) the address of registered office; (c) the defective entity action; (d) the date of the defective action; (e) the nature of the failure of authorization; (f) a statement that the action was ratified in accordance with the Title 15 Update; (g) information relating to any required filing, including a copy of such filing; and (h) applicable filing fees. The effective time of the validation will be the later of either (x) the time that all parties required to approve the action have approved the action, or (y) the effective time of any required statement of validation.[8]

Where interest holder approval is required, the entity must give notice to the then interest holders, regardless of whether they are entitled to vote. If ratification of a defective action does not require interest holder approval, the entity may provide an optional notice to the then interest holders. Upon receipt of the notice, a challenge to the validation must be brought within 120 days. Any challenge may only be brought to the validation by an interest holder, successor entity, a party affected materially and adversely by the defective action, or a member of the governing body of the entity.[9]

Finally, the bill separately provides that, after the passage of the earliest of several specified periods of time that depend on the status of the entity and the type of any prior notice or disclosure regarding the action, defective entity actions cease to be void or voidable for failure of authorization. Broadly speaking, the periods are (a) two years (in the case of a registered corporation that has disclosed the defective entity action in a filing with the U.S. Securities and Exchange Commission); (b) six years (in the case of defective entity actions set forth in a public filing with the Pennsylvania Department of State or otherwise disclosed to those whose approval would have been needed or to shareholders, in the case of the overissue of shares); and (c) if no other period applies, 21 years after the defective entity action. Before the expiration of the applicable period, a person otherwise entitled to assert that a defective entity action is void or voidable may file a court action seeking a declaration or other relief establishing that the defective entity action is void or voidable. The Title 15 Update temporarily suspends, until 2 January 2024, the operation of the statutory cleansing with respect to defective entity actions occurring before 2 January 2023, thereby creating a one-year opportunity for challenges to be brought with respect to those defective entity actions that might otherwise be cleansed by the new provisions.[10]

CONCLUSION

The Title 15 Update modernizes Pennsylvania's Associations Code, particularly the Business Corporation Law, in many respects. Where technical defects in authorization would otherwise preclude validation of certain entity actions, the Title 15 Update provides a clear path for ratification without the complications of voiding the action, and it provides an automatic bar on potential stale challenges to authorization. While the ratification process discussed above is not the only avenue available for ratification of defective actions, it provides a safe harbor for entities seeking to ensure that a defective action is properly remedied.

This Part 4 completes this multipart series discussing the Title 15 Update. Please contact the authors of this client alert or your primary contact at K&L Gates for further insight with respect to the Title 15 Update.

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FOOTNOTES

[1] H.B. 2057, Gen. Assemb., Reg. Sess. (Pa. 2022). Act 122 also made conforming changes to Title 54 (Names).

[2] 1 PA. CONS. STAT. § 1701(a)(5); see also H.B. 2057, § 112.

[3] *See*, e.g., H.B. 2057, § 5 (adding § 146(h) to the Associations Code).

[4] *Id*. at § 11 (adding §§ 221–229 to the Associations Code).

[5] *Id*. (adding §§ 222–228 to the Associations Code).

[6] *Id*. (adding § 222 to the Associations Code).

[7] *Id*. (adding §§ 223(c), 224(a), (e), 226(b)(2) to the Associations Code).

[8] *Id*. (adding §§ 221, 227(b) to the Associations Code).

[9] *Id*. (adding §§ 224(b), 225(a), 228(a), (d) to the Associations Code).

[10] *Id*. (adding § 229 to the Associations Code).

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