Delaware Case Confirms Validity of CEO's Removal

By:Joseph R. Martinez
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On March 14, 2014, the Delaware Supreme Court released the latest opinion in the ongoing case of *Klaassen v. Allegro Development Corporation et al*. The underlying controversy centers around the removal of a CEO by the corporation's board of directors with the added twist that the CEO was a controlling stockholder of the company. The arguments leading up to the most recent opinion included questions about what types of actions by a corporation can be considered "voidable" and might be subject to a cure after the fact versus those which are "void" and are incapable of being repaired or defended on equitable or any other grounds. Also at issue was whether the CEO was entitled to notice that the board was intending to remove him at a board meeting. This decision and two earlier Delaware Court of Chancery opinions are instructive for the stockholders of any venture-backed company with agreements regarding dedicated board seats, voting rights and other protective provisions.

Background

Eldon Klaassen was the founder and nearly 100% stockholder of Allegro Development Corporation ("Allegro") when the company received outside investment from two venture capital investors (the "Series A Investors"). The parties agreed to a fairly standard arrangement for a venture-backed company in which the Series A Investors were entitled to elect three directors (the "Preferred Directors"), the holders of the Common Stock (a class controlled by Klaassen) were entitled to elect one director (the "Common Director") and the holders of a majority of the outstanding voting power of the corporation (also controlled by Klaassen) would elect three remaining positions on a seven member board of directors (the "Remaining Directors"). Klaassen and the Series A investors also agreed that one of the Remaining Director seats would be filled by the CEO and the other two Remaining Directors would be designated by the CEO and approved by the Series A investors (the "Outside Directors"). Although the company's governing documents provided for a seven member board, at the time of the conflict, only five of the positions were filled: two Series A Directors, the CEO (Klaassen) and the two Outside Directors.

Within a few years of the investment, Allegro's performance was not meeting expectations and the board began to discuss replacing Klaassen as CEO. After some side discussions among individual directors and Klaassen, the other members of the board had some meetings without Klaassen. The meetings were deemed to be special meetings of the board of directors and Klaassen was never given notice of these meetings. No action to remove Klaassen actually took place at these special meetings, but, during them, the other directors did discuss and make plans to remove him. The Outside Directors also engaged in a bit of subterfuge with Klaassen, concealing their plans to remove Klaassen and using false pretenses to get him to have the company's general counsel attend a board meeting. At the next regular meeting of the board of directors, all of the directors, including Klaassen, participated and a majority of the directors elected to remove Klaassen as CEO. Initially, Klaassen appeared to accept the board's decision, going so far as to engage in negotiation of a consulting agreement for his services to Allegro and requesting changes to the board's compensation committee based on a requirement that committee members not be employed by the company. Seven months later, however, Klaassen asserted that he was still the company's CEO and claimed that he was removing the Outside Directors and filling the Common Director seat with a new person.

Legal Analysis

The Delaware Supreme Court's opinion upheld the earlier Chancery Court opinions and ruled against Klaassen with respect to his removal as CEO. The first part of the Supreme Court's ruling confirmed that prior notice of the board's intent to remove the CEO was not required. The Chancery Court's rulings on the notice requirement hinged on the fact that the act to remove Klaassen as CEO happened at a regular meeting of the board and not at one of the special meetings. The Supreme Court highlighted that it is settled law that corporate directors are not required to be given notice of regular board meetings and that there is no corresponding requirement that directors be given advance notice of the specific agenda items to be addressed at regular board meetings. The Court went on to say that Allegro's bylaws also did not override that default rule.

The Supreme Court next confirmed that the actions of the board to remove him were voidable, as opposed to being void. The Court noted that there are two types of corporate law claims – a legal claim and an equitable claim. A legal claim is based on an argument that a corporate action is improper because it violates a statute, the certificate of incorporation, a bylaw or another governing instrument, such as a contract. An equitable claim is grounded in the premise that the directors or officers have breached a fiduciary or equitable duty that they owe to the corporation and its stockholders. A legal claim can result in an action being deemed either void or voidable, but an equitable claim would not result in an action being declared void. The Supreme Court explained that a voidable act is one "which may be found to have been performed in the interest of the corporation but beyond the authority of management, as distinguished from [void] acts which are ultra vires, fraudulent or gifts or wastes of corporate assets." The Court characterized Klaassen's claims of deception as equitable ones which the Court determined implied that the board's actions were at most voidable, and not void. It went on to state that equitable claims are subject to equitable defenses. Equitable claims generally can only be advanced when a party has "clean hands" and are subject to a number of particular defenses which are also considered equitable. The Court of Chancery had previously ruled that Klaassen's deception claims were barred by the defendants' equitable defenses of acquiescence and laches. The Supreme Court found that Klaassen had indeed acquiesced to his removal as Allegro's CEO affirming the Chancery Court's opinion that Klaassen's overall conduct made it reasonable for the board to believe that he had accepted his replacement. The Court went on to outline some of requirements to determine when a party has acquiesced including: full knowledge of his or her rights and the material facts; freely doing what amounts to recognition of the complained of act; and acting in a manner inconsistent with the subsequent repudiation.

Conclusion

Advance notice that a CEO is going to be ousted at a board meeting is not required if the action takes place at a regular meeting of the board and the bylaws do not contain additional notice standards for regular meetings. Stakeholders in a venture-backed company, or any other corporation, with voting or other protective provisions in the certificate of incorporation or separate stockholder agreements should take care to consider the process by which corporate actions are approved and confirm that the requirements of the corporation's certificate of incorporation, bylaws and stockholder agreements are followed. Actions of a corporation's board, officers or stockholders which are contrary to a corporation's governing documents could be considered void and subject to negation. The Supreme Court opinion does not specifically address all of the matters taken up by the Chancery Court in Allegro, but the lower court's opinions on this matter also provide other instructive advice on this topic. The Chancery Court opinions go further into how investor rights agreements can be implemented to bind stockholders and also highlighting the importance of requiring significant stockholders to become parties to these agreements. Klaassen attempted to change the composition of the board after his removal in contravention of the stockholder agreement to which he was a party and his actions in contravention of the agreement were found to be invalid.

For further information on this topic, please contact **Joseph R. Martinez**.