Klaassen v. Allegro: Implementing the Stockholders' Agreement

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Delaware Business Court Insider

December 4, 2013

In venture capital financings, fund investors will typically negotiate with founders for various rights and protections, including dedicated board seats and protective provisions, to monitor and protect their investments. Many of these provisions are included in the certificate of incorporation; others, like the provisions identifying the individuals who will serve on the board, are less suited to being placed in the organizational documents and are instead included in stockholders' agreements. In some cases, the provisions included in stockholders' agreements are inconsistent with the provisions of the certificate of incorporation or are contrary in some respects to the Delaware General Corporation Law, giving rise to concerns over their enforceability.

In *Klaassen v. Allegro Development*, C.A. No. 8626-VCL (Del. Ch. Oct. 11, 2013), the Delaware Court of Chancery indicated that governance provisions included in stockholders' agreements may be enforceable against the parties to those agreements, even if the provisions conflict with the certificate of incorporation or the DGCL. The opinion offers guidance to venture capital investors and founders as they negotiate their respective governance rights.

In *Klaassen*, two venture capital funds negotiated for a fairly standard package of rights and protections in connection with their preferred stock investment in Allegro Development Corp. They secured various rights in the certificate of incorporation and bylaws and entered into a stockholders' agreement with Eldon Klaassen, Allegro's founder and chief executive officer. Following the funds' investment, Klaassen continued to hold a majority of the common stock and controlled a majority in voting power of the outstanding stock generally.

Allegro's certificate of incorporation entitled the holders of a majority of Allegro's voting power, voting as a single class on an as-converted basis (i.e., Klaassen), to elect three of the seven directors (the remaining directors). The stockholders' agreement set forth the manner in which the remaining directors would be identified and elected. Specifically, it provided that one of the three remaining directors would be Allegro's CEO, and that the other two would be individuals meeting certain conditions who were designated by the CEO and approved by the funds. The stockholders' agreement further provided that, subject to certain exceptions, the remaining directors could be removed only for cause.

A few years after the funds' initial investment, Klaassen was terminated as CEO. Subsequently, Klaassen, in his capacity as a stockholder, executed and delivered a written consent purporting to, among other things, remove two of the remaining directors and fill the resulting vacancies. In evaluating the validity of the removal of the remaining directors and the filling of the vacancies, the court explained that "under this governance structure, the charter and bylaws allocate various rights to the different classes of stockholders, then the stockholders' agreement adds a contractual overlay that constrains the manner in which parties to that agreement can exercise their rights. As the holder of a majority of Allegro's voting power, Klaassen possesses rights under the charter and bylaws to elect directors, remove directors and fill vacancies that he agreed not to exercise in the stockholders' agreement."

The court held that although Allegro's bylaw that required compliance with the stockholders' agreement to remove a director without cause impermissibly restricted the stockholders' power to remove directors without cause under Section 141(k) of the DGCL—Allegro did not have a classified board, and its certificate of incorporation did not provide for cumulative voting—and was therefore invalid as to a stockholder who was not a party to the stockholders' agreement, as to Klaassen, the removal of the remaining directors was only valid to the extent Klaassen complied with the applicable provisions of the stockholders' agreement. Similarly, as to the filling of the vacancies, although the provision of the bylaws that required the vacancies on the board to be filled in accordance with the stockholders' agreement "nominally conflict[ed]" with Section 223 of the DGCL, the certificate of incorporation and common law, Klaassen, as a party to the stockholders' agreement, was nonetheless required to comply with the terms of the stockholders' agreement in filling vacancies. Accordingly, to the extent Klaassen failed to comply with the stockholders' agreement in either removing the remaining directors or filling the vacancies created by such removal, such actions were invalid.

While the *Klaassen* opinion provides comfort to investors that the Chancery Court will recognize the governance arrangements on which the parties agreed, it nevertheless serves as a reminder that investors should take care to ensure that the rights for which they have negotiated in stockholders' agreements work in concert with the corporation's organizational documents and comport with the DGCL to the maximum extent possible. Given that the terms of the stockholders' agreement, if inconsistent with the organizational documents or the DGCL, may not be enforceable against nonparties, investors should ensure that all relevant parties have executed the stockholders' agreement and that the stockholders' agreement contains appropriate restrictions on stock transfers.

The stockholders' agreement should further require any proposed transferee to execute a counterpart to the stockholders' agreement consenting to be bound by its terms. In addition, the stockholders' agreement should include provisions granting a proxy and power of attorney to the nonbreaching party in respect of the shares held by any party who has breached the terms of the agreement. The inclusion of such provisions will give investors greater certainty that the governance arrangements for which they negotiated will be observed and maintained.

The plaintiff has appealed the Court of Chancery's decision in *Klaassen* and the Delaware Supreme Court has granted the plaintiff's motion to expedite, with oral argument scheduled for Dec. 18.

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