RECENT CASE INTERPRETING VOTING AGREEMENT HIGHLIGHTS DELAWARE LAW TRAPS

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A recent order by the Delaware Court of Chancery that interprets voting provisions contained in many typical private equity, venture capital, and other stockholder documents invalidated action taken by the holders of a majority of the common stock of a Delaware corporation to remove and replace members of the corporation's board of directors and management. This serves as a cautionary reminder that governance provisions in private equity and venture capital financing documents must be reviewed against the backdrop of Delaware law to ensure the effectiveness of the parties' bargained-for rights. Dictum in the Court's decision also indicates that a provision granting stockholders a right to remove directors might be valid if contained in a corporation's certificate of incorporation or bylaws but not in a stockholders' or voting agreement, departing from an earlier decision.

I. BACKGROUND.

Schroeder v. Buhannic [1] involved venture-backed TradingScreen, Inc., a Delaware corporation (the “Company”). Defendant Philippe Buhannic, the Company's founder, along with a family member stockholder, purported to (1) remove and replace Pierre Schroeder from his capacities as both (a) the Company's CEO and (b) a director and Chairman of the Board of Directors; and (2) remove and replace Piero Grandi as the Company's independent director by action via written consent of the holders of a majority of the Company's common stock (the “Consent”). Schroeder and Grandi subsequently brought this action under Section 225 of the General Corporation Law of the State of Delaware (the “DGCL”). Plaintiffs sought a declaration that the Consent was ineffective under the Company's Amended and Restated Certificate of Incorporation (the “Charter”), the Company's bylaws, and a stockholders' agreement among the Company and its stockholders (the “Stockholders' Agreement”). The Court found the Consent invalid on plaintiffs' motion for judgment on the pleadings.

II. ANALYSIS.

A. Removal of an Officer by the Stockholders

The Court found the Consent ineffective to remove Mr. Schroeder as the Company's CEO, holding that the power to hire and fire officers rests solely with the Company's Board of Directors. In its reasoning, the Court noted that Section 142 of the DGCL provides that “[o]fficers shall be chosen in such manner and shall hold their offices for such terms as are prescribed by the bylaws or determined by the board of directors or other governing body.” Article IV, Section 3 of the Company's bylaws provides that “[a]ny officer of the Corporation may be removed, either with or without cause, at any time, by the board of directors at any meeting thereof, but such removal shall be without prejudice to the contract rights, if any, of the person so removed.”

B. Removal of the CEO-Director

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The Court next held that the removal of Mr. Schroeder as a director was invalid under the Stockholders' Agreement. Under Section 7.2(b) of the Stockholders' Agreement ("Section 7.2(b)"), all stockholders agreed to elect and maintain as directors of the Company "three (3) representatives designated by the holders of a majority of the Common Stock, one of whom shall be the Chief Executive Officer". Plaintiffs contended that Section 7.2(b) (1) required the common stockholders to elect to the Company's Board the CEO who had been duly appointed as such officer by the Company's Board, and (2) prohibited the common stockholders from removing the CEO from his director position. Defendants argued that Section 7.2(b) permitted the common stockholders to appoint anyone to the Board of Directors and required the Board of Directors to choose a CEO from one of the directors nominated by the common stockholders. The Court sided with the plaintiffs' position as the only reasonable interpretation after considering it in the context of, among other things, (1) parallel provisions of the Stockholders' Agreement granting various stockholder constituencies director designation rights; (2) the bylaws, which provided that the board must select the CEO and that the CEO need not be a director; and (3) Delaware law, which holds that the appointment and removal of an executive officer is a core board function that may only be limited by the certificate of incorporation or the bylaws, not a stockholders' agreement. With respect to the third point, the Court suggested that although *Gorman v. Salamone* [2] held that the power to remove an officer could not even be limited by a bylaw provision, the Court might find a bylaw provision limiting the board's authority to remove officers to be valid.

The Court also noted that the removal of Mr. Schroeder as a director by the holders of a majority of the common stock conflicted with and was potentially invalid under the Charter and bylaws. Article IV, Section C.5 of the Charter provides that "the holders of shares of the Series D Preferred Stock and the Common Stock shall vote together (or render written consents in lieu of a vote) as a single class on all matters submitted to the stockholders of the Corporation." The Charter did not contain a provision frequently seen in certificates of incorporation for venture-backed companies that would mirror the arrangements in a company's voting agreement or stockholders agreement and thus would have granted the holders of common stock a right, as a separate voting class, to elect and removed a specified number of director(s). Article III, Section 10 of the bylaws provides that any director of the Company "may be removed, at any time, with or without cause, by the affirmative vote of the holders of record of a majority of the outstanding shares of stock entitled to vote at a meeting of stockholders." Based on the foregoing, the Consent was only effective to remove Mr. Schroeder if it represented a majority of the voting power of the Company's common stock and Series D Preferred Stock, voting together as a class. Whether the Consent represented the requisite voting power to remove Mr. Schroeder as a director was a factual issue not capable of resolution on a motion for judgment on the pleadings. Given the Court's conclusion that the removal of Mr. Schroeder as a director violated the Stockholders' Agreement, the Court determined that it did not need to address the additional issue of whether the Consent also violated the Charter and the bylaws.

C. Removal and Replacement of the Independent Director

The Consent also purported to appoint nonparty Scott Freeman as an independent director pursuant to Section 7.2(c) of the Stockholders' Agreement ("Section 7.2(c)"). Section 7.2(c) requires the holders of a majority of the Series D Preferred Stock to consent to the election of the independent director. Defendants admitted that the holders of a majority of the Series D Preferred Stock did not consent to Mr. Freeman's election, and the Court therefore held Mr. Freeman's election ineffective. The Consent also purported to remove plaintiff Piero Grandi as the independent director for cause without providing him with any of the procedural protections required under

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Delaware law to remove a director for cause, including notice and the opportunity to contest the charges. The Court found the Consent ineffective to remove Mr. Grandi as the independent director. Although removals of directors for cause are infrequent, this case serves as a helpful reminder that Delaware law provides certain procedural protections for such directors before they may be removed by stockholders for cause and that care should be taken to comply with such protections.

III. CONCLUSION

This case underscores the importance of proper placement and drafting of investor protective provisions in equity financing documents. These documents frequently provide that the portfolio company's CEO shall be a director of the company and include some type of requirement that the stockholders elect the current CEO as a director of the company. *Schroeder* makes clear that governance provisions in stockholders' agreements for private equity and venture capital financings will be interpreted against the backdrop of Delaware law, which grants the board the primary authority to remove and replace officers. Section 141(a) of the DGCL provides that a corporation's board of directors manages the business and affairs of the corporation *unless otherwise provided in the certificate of incorporation*. Thus, if investors, in their capacities as stockholders, desire to have some control over the board's appointment or removal of the CEO, counsel might consider negotiating for a class vote, protective provision, or other blocking right over the hiring and firing of officers and place such right in the corporation's certificate of incorporation to avoid arguments that stockholder control over the board's appointment and removal of officers infringes upon the board's managerial authority under Section 141(a) of the DGCL.

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[1] C.A. No. 2017-0746-JTL (Del. Ch. Jan. 10, 2018) (ORDER).

[2] 2015 WL 4719681 (Del. Ch. July 31, 2015).

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