Terminating the CEO: Some Practice Tips from the Delaware Supreme Court

When the directors of a public company lose confidence in their chief executive officer and choose to remove him or her, the communication of that message is typically a highly choreographed affair. A recent decision of the Delaware Supreme Court, sitting *en banc* in *Klaassen v. Allegro Development Corp.*,[1] provides the opportunity to review some basics of Delaware board process and highlights the need to be careful about both a Delaware law technicality involving the difference between regular and special board meetings, and what should be a more common sense aversion to the use of deception in the choreography. The Supreme Court in *Klaassen* affirmed a Chancery Court decision, by Vice Chancellor Laster,[2] which the Vice Chancellor stayed pending appeal.

Eldon Klaassen founded Allegro in 1984 and was its CEO until November 1, 2012. Klaassen also owned nearly all of Allegro's stock until late 2007 and early 2008, at which time Allegro raised capital through the sale of a preferred class of stock to two private equity firms. Following the investment, Allegro's board consisted of two members appointed by the new investors, two members appointed by Klaassen in his capacity as CEO and approved by the new investors, and Klaassen.

The Allegro board eventually became dissatisfied with Klaassen's leadership and, at a regularly scheduled board meeting on November 1, 2012, terminated his employment and appointed one of the board members appointed by Klaassen as interim CEO. Klaassen remained as a director. Although Klaassen acted initially in a manner suggesting acceptance of the change – *e.g.*, he agreed to serve on the audit and compensation committees of the board at a subsequent board meeting – by mid-2013 Klaassen sent a letter to Allegro's general counsel and two of its board members arguing that his removal as CEO was invalid.

The Chancery Court ruled against Klaassen, but in a post-trial memorandum opinion addressing Klaassen's motion for a stay pending appeal reviewed at length a line of cases dealing with notice requirements for board of director meetings, beginning with a 1992 Chancery Court opinion in the case of *Koch v. Stearn*[3]. Klaassen argued that these cases "recognize a special equitable notice requirement that benefits any individual who is (i) both an officer and a director and (ii) can exercise a right that could alter the composition of the board."[4] Basically, the alleged rationale for such a special notice requirement was that the absence of notice improperly deprived the "super-director" of the ability to exercise his right to change the composition of the board so as to pre-empt the board's plans. The Chancery Court concluded

[1] *Klaassen v. Allegro Development Corp.*, No. 583, 2013 (Del. Mar. 14, 2014).
[2] *Klaassen v Allegro Development Corp.*, C.A. No. 8628-VCL (Del. Ch. Oct. 11, 2013).
[3] *Koch v. Stearn*, 1992 WL 181717 (Del. Ch. July 28, 1992).
[4] *Klaassen v. Allegro Development Corp.*, C.A. No. 8626-VCL, slip op. at 7 (Del. Ch. Nov. 7, 2013).

that the *Koch* line of cases "reveals tensions…with Delaware's director-centric system of corporate governance…[but does] present serious legal questions" relevant to the claim in *Klaassen*.[5] While the Chancery Court's review of the *Koch* line of cases was interesting and entertaining from a historical and theoretical perspective, the Chancery Court ultimately avoided deciding *Klaassen* on the basis of those cases, instead holding against Klaassen on the basis of the equitable principle that Klaassen had acquiesced in the termination of his employment.

In affirming the Chancery Court's decision, the Supreme Court sidestepped the Chancery Court's questioning of the holdings of the *Koch* line of cases ("we need not respond to that question, as an answer is not required to resolve this case"[6]) and instead resolved Klaassen's appeal in favor of Allegro and the defendant directors on the basis of a straightforward application of Delaware's notice requirements and of equitable principles.

The notice requirement distinction with respect to regular and special meetings is an important practice point that can be easily overlooked in the context of terminating the employment of a chief executive officer, when typically very few, if any, people who might be facile with the minutiae of the Delaware General Corporation Law are brought into the loop:

> "It is, of course, fundamental that a special meeting held without due notice to all the directors is not lawful, and all acts done at such meeting are void. 10 Cyc. 784, 785. As to regular, or stated, meetings the rule is different. Presence at the meeting waives the notice, and so may a waiver be properly executed before the meeting, for there is still an opportunity to attend it. But a waiver subsequent to the meeting is ineffective."[7]

The terms "regular meeting" and "special meeting" are, also of course, not defined in the Delaware General Corporation Law but refer, often but not always as specified in a corporation's by-laws, to meetings that are, respectively, scheduled in advance and on a regularized basis, or not. The Supreme Court's decision in *Klaassen* strongly implies, although the issue is *dicta*, that directors must be given "advance notice of the specific agenda items to be addressed" at special board meetings in order for the actions at those meeting not to be *void*.[8] That requirement, to be clear, does not depend on whether any employee director would have the ability to influence the composition of the board if given notice.

As to the issue of deception, while Klaassen had reason to know that his tenure as CEO of Allegro was in jeopardy, the Supreme Court found that the other Allegro directors "decided not to forewarn Klaassen that they planned to terminate him, because they were concerned about how Klaassen would react while still having access to Allegro's intellectual property, bank accounts, and employees."[9] Klaassen argued that the directors' real concern was that they would be replaced by him. The Supreme Court also concluded that one of the defendant directors sent Klaassen a misleading email, asking if the company's general counsel could attend the climactic board meeting in order to address preferred stock redemption issues, when in fact he was needed to implement the termination immediately after Klaassen was notified.

[5] *Id.* at 7-8.
[6] *Klaassen v. Allegro Development Corp.*, No. 583, 2013, slip op. at 21 n.65 (Del. Mar. 14, 2014).
[7] *Lippman v. Kehoe Stenograph Co.*, 95 A. 895, 898 (Del Ch. 1915).
[8] *Klaassen v. Allegro Development Corp.*, No. 583, 2013, slip op. at 19 (Del. Mar. 14, 2014).
[9] *Id.* at 11.

Against that backdrop, and the fact that the Supreme Court decided the case in favor of the defendants, the Supreme Court quite understandably began its analysis of the equitable issues in the case by noting that "our courts do not approve the use of deception as a means by which to conduct a Delaware corporation's affairs, and nothing in this Opinion should be read to suggest otherwise."[10] Still, the Supreme Court held that under equitable principles the Allegro board's action was voidable, and not *per se* void, and that Klaassen's claim would therefore fail because of his acquiescence in the decision. In the course of so concluding, the Supreme Court overruled any portions of the *Koch* line of cases that suggests that a board action carried out by means of deception is *per se* void, not voidable.

The disposition of the equitable claim in *Klaassen* presents an important practice point. As it did with questions concerning the interpretation of the *Koch* line of cases, on the question whether the deception alleged by Klaassen was enough to potentially void the board's decision to terminate him, the Supreme Court sidestepped the issue ("we need not address the merits of Klaassen's deception claim, because we find…that Klaassen acquiesced").[11] In the context of terminating a chief executive officer, as in any good drama, the urge to use minor deceptions is often strong. Acceding to that urge can, depending on the facts and circumstances, have real consequences.

If you have any questions, please do not hesitate to reach out to your regular contacts at the Firm or any of the persons listed in the [Corporate Governance](#) Practice section of our website (www.cgsh.com).

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[10] *Id.* at 23.
[11] *Id.*

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