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Venture Capital Firms and Founders Should Heed Delaware Court Decision

Law360

06.23.2017

Venture capital firms and founders of companies should take note of a recent important ruling from the Delaware Court of Chancery. In a case of first impression, the court rejected a venture capital firm's effort to employ Section 204 of Delaware General Corporation Law (DGCL) to ratify an amendment to the company's charter that would have forced the founder out of the company. While many companies use the model legal documents from The National Venture Capital Association (NVCA), this ruling highlights the need for both sides to carefully negotiate the amendment provisions that are commonly used in the NVCA forms — specifically the voting agreements — which establish the parties' roles in managing the company's future.

Defendant View, Inc. ("Company"), a closely held corporation, develops and sells windows that allow the light, heat, and glare to be controlled manually. Plaintiff Paul Nguyen ("Founder") is the founder, and at all relevant times, owner of 70% of the Company's common stock. In 2007, the Company accepted investment from two venture capital firms as part of the Company's Series A Financing. As a result of the Series A Financing, the two venture capital firms acquired Series A preferred stock, and the parties entered into a voting agreement affecting the management of the Company. The voting agreement established the size and composition of the Company's board, in which the venture capital firms gained control over the corporate structure and composition of the five-person board. The Founder, however, retained the right to name one member of the board. Thereafter, the Founder's only means of protecting his interests were a class vote provision under 8 DEL. C. § 242(b)(2) and those rights afforded him under the voting agreement.

In 2009, the Company took action to limit the Founder's involvement in the Company's affairs, namely his removal as a member and chairman of the board of directors as well as termination of his employment. This action riled the Founder, and the parties pursued mediation. While the parties participated in mediation, the venture capital firms caused the Company to amend its charter to increase the number of authorized shares of common stock in connection with the issuance of convertible notes. The Founder did not consent to the amendment. A few months later, the venture capital firms further amended the Company's charter to increase the number of authorized shares of common stock in connection with the additional issuance of convertible notes. Again, the Founder did not consent to this action. The Company also informed the Founder that it anticipated raising additional capital in a Series B Financing and requested the Founder's approval of related financing documents. In addition to raising capital, the Series B Financing sought to strip holders of common stock of their right to appoint board members, eliminate the Founder's consent right to any amendments to the voting agreement, and waive the right of the majority common stockholder to approve any amendments to the certificate of incorporation affecting the number of shares of common stock. The Founder expressed concern with the proposal, but ultimately consented to the Series B Financing as a part of a global settlement of claims. The settlement agreement included a seven-day right of rescission period, which the Founder exercised within the time allotted. Unbeknownst to the Founder, the Company had already consummated the Series B Financing during the rescission period.

The Series B Financing forced the Founder to pursue arbitration, seeking a declaration that the rescission of the settlement agreement was valid, and thus, the Series B Financing was void. During the course of arbitration, the Company participated in Series C through F Financings. The arbitrator ultimately found that the Founder properly exercised his right of rescission under the settlement agreement, thereby invalidating the Series B through F Financings. Nevertheless, the Company, utilizing Section 204 of the DGCL, filed two certificates of ratification concerning those amendments to the charter that allowed for an increase in the number of authorized shares of common stock.

Following the arbitrator's decision, the venture capital firms, who held the Series A preferred shares, converted their preferred shares to common stock, effectively removing the Founder as the majority common stockholder and allowing for the cancellation of the voting agreement. The Company then filed two certificates of correction and twenty-two certificates of validation to ratify certain defective charter amendments, including the Series B Financing that the arbitrator had previously declared void.

The Founder commenced an action to challenge the certificates of validation under Sections 204 and 205 of the DGCL. The Company moved to dismiss the verified complaint on the basis that the Founder failed to show that the ratification was invalid. The motion required the Court to determine whether an act that the majority of stockholders entitled to vote rejected, which the Company subsequently determined was permissible, constituted a "defective corporate act" under Section 204 of the DGCL. This question presented an issue of first impression that the Court sought to answer through statutory interpretation.

Section 204 of the DGCL is a "safe harbor procedure" intended to help corporations validate acts that are otherwise void or voidable. The section "provides that 'no defective corporate act … shall be void or voidable solely as a result a failure of authorization if ratified as provided in this section or validated by the Court of Chancery in a proceeding brought under § 205 … .'" Subsection (a) defines the term defective corporate act as "any act … purportedly taken by or on behalf of a corporation that is, and at the time such act or transaction was purportedly taken would have been, within the power of a corporation … but is void or voidable due to a failure of authorization." If properly invoked, this section provides "an adaptable, practical framework" by which corporations can correct certain mistakes.

The Court first placed the legal issue in context. Prior to the settlement agreement, the Founder, as the majority common stockholder, possessed the right to approve any amendments to the Company's charter that affected the number of shares entitled to vote. The settlement sought to strip the Founder of these rights, and he rescinded the agreement to preserve his interest.

"Section 204 makes clear that the defective corporate acts that a corporation purports to ratify must be within the corporation's power 'at the time such act was purportedly taken.'" While the certificates of ratification sought to affirm the Series B Financing, the Founder opposed the action by withholding his consent. Thus, at the time that the Company sought to participate in the Series B Financing, it did not possess the requisite authority to do so without the Founder's approval.

The Company sought to counter the Court's finding by arguing that the Series B Financing was a "failure of authorization" which could be ratified under Section 204 of the DGCL. The Court disagreed, finding that the Founder's rescission of the settlement agreement and revocation of authority for the Series B Financing did not constitute a failure of authorization but rather an outward rejection of the proposal. Failure and rejection are fundamentally different concepts, in which failure is defined as an "omission of occurrence or performance," while rejection encompasses a refusal "to accept, consider, submit to, take for some purpose, or use." Thus, the amendments did not qualify under Section 204 of the DGCL. Further, the Company argued that the conversion of the preferred shares to common stock created the necessary conditions for retroactively authorizing the amendment. The Court found that neither the statutory text nor legislative history of Section 204 of the DGCL sought to sanction the type of result advocated for by the Company: "Section 204 is not a 'license to cure just any defect.' Indeed, it cannot be used to authorize retroactively an act that was never taken but that the corporation now wishes had occurred, or to 'backdate' an act that did not occur but that the corporation wishes had occurred as of an earlier date." Accordingly, the Court found that the Founder pleaded facts that supported his request for relief and denied the Company's motion to dismiss.

The Court's decision is significant in light of the role that venture capitalists play in the development of startups and emerging growth companies and their evolving relationship with the founders of these companies. In most venture capital financings, the relevant parties will enter into a voting agreement that sets forth the terms and conditions for how the shares of a company's capital stock are voted with respect to the composition of the board of directors, and voted or tendered in connection with an acquisition of the company. Generally speaking, an amendment to or waiver of a provision in such a financing agreement requires the consent of the company, the key holders (who are commonly the founders), and the investors. Investors can limit the risk associated with recalcitrant founders stalling or obstructing efforts by the company to raise additional capital if the founder's right to consent to an amendment is tied to the founder's continued provision of services, such that if a founder was terminated, he or she would lose his or her right to consent. Meanwhile, founders should remain wary of provisions of this sort, as there is ample precedent of investors forcing founders out of a company. In closing, parties would be wise to closely scrutinize the language included in financing documents, specifically voting agreements, which not only affect their rights, but also serve as the foundation for the parties' relationship in guiding the future of the company. The facts of, and decision in, this case provide a stark example of the reality that while investors and founders generally have interests that are largely aligned, each likely seeking to increase, maximize and sustain value, there also remain significant areas of diverging interests. These interests must be considered in connection with a financing transaction and other corporate governance matters.

The above referenced case is *Nguyen v. View, Inc.*, C.A. No. 11138-VCS (Del. Ch. June 6, 2017).