

April 20, 2010

## Delaware Court Addresses Applicability of Implied Covenant of Good Faith and Fair Dealing

In its recent decision in *Nemec v. Shrader*, the Delaware Supreme Court upheld the Delaware Chancery Court's dismissal of a claim by two former stockholders that a board breached a stock plan's implied covenant of good faith and fair dealing, stating that the Delaware courts should only imply terms into contracts when the non-asserting party is shown to have acted unjustly and in so doing has frustrated "the fruits of the bargain that the asserting party reasonably expected." The Court also upheld the dismissal of fiduciary duty and unjust enrichment claims against the directors.

### Background

The claims in the *Nemec* case arise from the redemption of the plaintiffs' shares of stock in Booz Allen ("Booz Allen") prior to the sale of Booz Allen's government consulting business to The Carlyle Group ("Carlyle"). The plaintiffs retired as officers of Booz Allen on March 31, 2006. During their employment, the plaintiffs were partially compensated with annual grants of stock rights under the Booz Allen officers stock rights plan (the "Stock Plan"). Under the Stock Plan, at any time after the second anniversary of an officer's retirement, Booz Allen could redeem such officer's stock issued under the Stock Plan, in whole or in part, at book value. In November 2007, Carlyle made an offer to purchase Booz Allen's government consulting business and on May 15, 2008, Booz Allen entered into an agreement with Carlyle to effect such sale. The transaction with Carlyle was closed on July 31, 2008.

The plaintiffs' claims arise from Booz Allen's redemption in April 2008 of their shares at their then-current book value of approximately \$162.46 per share. Had the shares not been redeemed and the retired stockholders been permitted to partake in the sale to Carlyle, they would have received significantly more value per share (approximately \$700 per share) than they received in the redemption. However, the failure to redeem the retired stockholders' shares would reduce the total sale consideration payable to the working stockholders by \$60 million. The plaintiffs asserted three claims related to the redemption: (i) a breach of an implied covenant in the Stock Plan to "exercise the redemption right in good faith and to deal fairly with the plaintiffs," (ii) a breach of the board of director's fiduciary duty of loyalty and (iii) unjust enrichment of the directors of Booz Allen.

### Breach of Implied Covenant of Good Faith and Fair Dealing

The implied covenant of good faith and fair dealing is imposed on all Delaware contracts and allows the courts to imply terms into a contract in order to address unforeseen events or contractual gaps. The Court held that if conduct is permitted under an agreement – noting that the Stock Plan expressly permitted the redemption of the plaintiffs' shares at the time and price they were redeemed – a party generally cannot make a claim for a breach of this implied covenant.

The Court noted that it would only imply terms into a contract “when the party asserting the implied covenant proves that the other party has acted arbitrarily or unreasonably, thereby frustrating the fruits of the bargain that the asserting party reasonably expected.” The Court maintained that the implied covenant does not apply to events that the parties *failed to consider* during negotiations, but rather that it applies only to events that *could not have been anticipated* by the parties. In upholding the Delaware Chancery Court’s dismissal, the Court stated that the implied covenant is a “limited and extraordinary legal remedy” and concluded that “[c]rafting, what is, in effect, a post contracting equitable amendment that shifts economic benefit from working to retired partners would vitiate the limited reach of the concept of the implied duty of good faith and fair dealing.”

### Breach of Fiduciary Duty of Loyalty

The plaintiffs’ second claim was that the directors of Booz Allen breached their fiduciary duty of loyalty by causing Booz Allen to redeem the plaintiffs’ shares prior to the closing of the Carlyle transaction in order “to further [the directors] own economic self interest.” The Court affirmed that disputes that are based upon explicit contractual obligations should be treated as breach of contract claims, rather than breach of fiduciary duty claims, and declared that it would be “superfluous” to allow a plaintiff to make a fiduciary duty claim based on the same facts that a breach of contract claim could be made on. The Court held that the directors of Booz Allen were exercising a contractual right in approving the redemption and therefore that a separate fiduciary duty claim by the plaintiffs was barred.

### Unjust Enrichment

The plaintiffs’ final claim was that the directors were unjustly enriched as a result of the redemption of the plaintiffs’ shares prior to the consummation of the Carlyle transaction. In dismissing this claim, the Court noted that the Delaware courts will not allow a claim of unjust enrichment “when the alleged wrong arises from a relationship governed by contract”, and also found that the plaintiffs failed to demonstrate all five elements necessary for a successful unjust enrichment claim.

### Dissent

Justices Jacobs and Berger dissented from the majority’s opinion stating that the majority made its ruling based on an incomplete, albeit correct, statement of the law. The dissenting justices noted that Delaware case law confirms that “a contracting party, even where expressly empowered to act, can breach the implied covenant if it exercises that contractual power arbitrarily or unreasonably.” The dissenting justices went on to state that they believed the plaintiffs had made a cognizable claim since they alleged facts that could demonstrate that the redemption was arbitrary and unreasonable given that it achieved no justifiable benefit to Booz Allen while prejudicing the retired stockholders.

This memorandum is intended only as a general discussion of these issues. It should not be regarded as legal advice. We would be pleased to provide additional details or advice about specific situations if desired.