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Corporate Governance Group Client Alert

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DELAWARE COURT OF CHANCERY RELIES ON TERMS OF EMPLOYEE STOCK PLAN TO DETERMINE RIGHTS OF SHAREHOLDERS

Dismisses Claims of Breach of Fiduciary Duty and Breach of the Implied Covenant of Good Faith and Fair Dealing in Connection with Directors' Decision to Redeem Shares

Two previous Client Alerts highlighted the reluctance of Delaware courts to look beyond the negotiated terms of a contract in determining the duties and obligations of the contracting parties.¹ In *Fisk Ventures, LLC v. Segal*,² the Court of Chancery focused on the terms of a limited liability company operating agreement, rather than looking to fiduciary duties or the implied covenant of good faith and fair dealing, in resolving a dispute among members of the LLC. Similarly, in *In Re Appraisal of Metromedia International Group, Inc.*,³ the Court of Chancery, in valuing shares held by preferred shareholders dissatisfied with the terms of a merger, rejected extrinsic valuation methodologies typically used under Delaware's appraisal statute in respect of common stock, relying instead on the valuation methodology specified in the instrument governing the rights of the preferred shareholders.

On April 30, 2009, the Court of Chancery applied the principle underlying both *Fisk* and *Metromedia* in a case involving a disputed stock redemption. In *Nemec v. Shrader*,⁴ the Court repeated its view that where parties' rights are governed by a contract, courts should not apply fiduciary duty concepts or look to implied covenants to change the benefits bargained for by the parties to the contract.

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¹ See our Client Alerts entitled "Delaware Chancery Court Grants Dismissal of Fiduciary Duty Claims Raised Against Members of a Limited Liability Company" (June 2, 2008), and "Delaware Court of Chancery Adheres to Preferred Stock Valuation in Certificate of Designation For Purposes of Appraisal Proceeding" (May 11, 2009).

² *Fisk Ventures, LLC v. Segal*, 2008 WL 1961156 (Del. Ch. May 7, 2008).

³ *In re Appraisal of Metromedia International Group, Inc.*, No. 3351-CC (Del. Ch. April 16, 2009).

⁴ *Nemec v. Shrader*, C.A. No. 3878-CC (Del. Ch. Apr. 30, 2009).

Background

On March 31, 2006, plaintiffs Joseph Nemeč and Gerd Wittkemper retired as officers of Booz Allen Hamilton Inc., a leading strategy and technology consulting firm incorporated in Delaware and headquartered in Virginia. Nemeč and Wittkemper had been with the company for 36 years and 20 years, respectively, and had risen to levels of prominence. Throughout their tenure, plaintiffs were compensated, in part, with annual stock rights that could be converted into common stock of the company. At the time of their retirements, Nemeč owned 76,000 shares and Wittkemper owned 28,000 shares. Under the Stock Plan governing the award of the stock rights, each plaintiff had the option to sell his shares back to the company at book value for a period of two years following the date of his retirement. Following this period, the company had the option under the Stock Plan to redeem the shares at book value. By the end of the two-year periods following their respective retirements, Nemeč had elected to retain all of his shares and Wittkemper had elected to retain most of his shares.

In the summer of 2007, Booz Allen began active consideration of a “game changing opportunity” – the sale of its government consulting business, one of its two major business lines. In November 2007, The Carlyle Group, a private equity firm, offered to buy the business for \$2.54 billion. Because the transaction was expected to close before the end of Booz Allen’s fiscal year on March 31, 2008 – the first date that the company’s option to require redemption of the shares owned by Nemeč and Wittkemper could be exercised under the Stock Plan – plaintiffs expected to share in the profit generated by the transaction on the same basis as all other Booz Allen shareholders. This was significant because the price per share that plaintiffs stood to receive as part of the transaction was projected to be much higher than the price payable in a redemption.

When they learned that the closing date for the Carlyle transaction had been pushed beyond March 31 while the parties awaited receipt of an IRS private letter ruling, plaintiffs sought and received assurance from Ralph Shrader, Booz Allen’s Chairman and CEO, that their shares would not be redeemed prior to the transaction’s closing. Shrader apparently characterized this assurance as an “easy moral decision.” Nevertheless, in April 2008 Booz Allen’s board (whose members collectively owned more than 300,000 shares in the company) acted to redeem plaintiffs’ stock at the pre-transaction book value of \$162.46 per share. A month later, the transaction with Carlyle (which was structured as a merger) closed, netting each remaining shareholder \$700 per share. In addition to depriving plaintiffs of the additional merger consideration, the board’s decision to redeem plaintiffs’ shares added \$6 million to the proceeds received by the directors for their shares in the transaction.

Plaintiffs filed suit against the Booz Allen directors, alleging that they had breached their fiduciary duty of loyalty because they “knew that they were awarding themselves millions of dollars when they redeemed plaintiffs’ stock, while at the same time depriving plaintiffs of economic benefits.” In addition, plaintiffs alleged that the directors breached the implied covenant of good faith and fair dealing contained in the Stock Plan because, “in exercising its option to redeem the plaintiffs’ shares, Booz Allen did not have the obligation to redeem; it had a choice and by exercising that choice, to the plaintiffs’ detriment, it violated the implied covenant of good faith and fair dealing.”

The defendant directors' motion to dismiss these claims was granted by the Court.⁵ Chancellor Chandler summed up the Court's position succinctly by writing that "[w]hile I sympathize with plaintiffs' sense of betrayal for not ultimately receiving the once-in-a-lifetime benefit they hoped for, plaintiffs entered into a negotiated contract and received the benefit for which they bargained."

The Court's Analysis

Breach of Fiduciary Duty

The Court began its analysis of plaintiffs' breach of fiduciary duty claim by noting that under "Delaware law, where a dispute 'relates to obligations expressly treated ...' by contract, it will be governed by contract principles." In such an event, "any fiduciary duty claims will be dismissed." Inasmuch as the relationship between plaintiffs and the company was governed by a contract, namely the Stock Plan, the Court dismissed plaintiffs' fiduciary duty claim, stating that "whether the directors possessed the right to redeem plaintiffs' shares and whether the directors properly exercised that right is simply a matter of contract interpretation."

Despite this holding, the Court proceeded to analyze the merits of the fiduciary duty claim and determined that even if the claim went forward, it would fail because the "directors do not owe separate and distinct fiduciary duties to the plaintiffs." According to the Court, as long as corporate directors properly exercise their reasonable business judgment, they may take any action that serves the interest of the company or the shareholders collectively. By not even disputing that Booz Allen's directors made an "informed and reasonable business decision" in redeeming their shares, plaintiffs were hard put to convince the Court that harm caused to two individual shareholders rendered the decision to redeem plaintiffs' shares a breach of the directors' fiduciary duties.⁶ The Court, quoting a previous decision,⁷ noted that reasonable board actions that "best serve the interests of the corporation or the entire body of shareholders" will, at times, "adversely affect the interests of a particular shareholder subgroup;" however, such effects "will, in certain instances, be unavoidable."

Breach of the Implied Covenant of Good Faith and Fair Dealing

The Court next turned to plaintiffs' claim that the directors violated the implied covenant of good faith and fair dealing in the Stock Plan by exercising the option to redeem plaintiffs' shares. According to the Court, "parties 'cannot base a claim for breach of the implied covenant on conduct authorized by the terms of the agreement.'" Rather, "the doctrine of the implied covenant of good faith and fair dealing 'requires a party in a contractual relationship to refrain from arbitrary or unreasonable conduct which has the effect of preventing the other party to the contract from receiving the fruits of the bargain.'" In short, the Court clarified that the implied covenant of good faith and fair dealing is a tool used to ensure that the terms of a contract are fulfilled, and that each side gets what it bargained for. However, according to the Court, such use by courts "should be rare."

⁵ Though beyond the scope of this Client Alert, it should be noted that plaintiffs also filed a claim alleging unjust enrichment on the part of the directors. That claim was dismissed by the Court, which noted that "Delaware courts... have consistently refused to permit a claim for unjust enrichment when the alleged wrong arises from a relationship governed by contract."

⁶ The Court even intimated that the board's failure to redeem plaintiffs' shares might have had consequences because that "would have reduced the value of the shares held by all of the other shareholders."

⁷ *Gilbert v. El Paso*, 1988 WL 124325 (Del. Ch. Nov. 21, 1988), *aff'd*, 575 A.2d 1131 (Del. 1990).

In the case of the Booz Allen Stock Plan, the Court noted that all the parties “understood the nature of the bargain they had negotiated and the risk that the outcome of the arrangement may benefit one party over the other.” In fact, the Court observed that “[c]ontractually negotiated put and call rights are intended by both parties to be exercised as the time that is most advantageous to the party invoking the option.” Consequently, the Court found that the directors had not breached the implied covenant of good faith and fair dealing by merely exercising the redemption rights under the Stock Plan.

Conclusion

The *Nemec* decision re-affirms that where a dispute relates to rights or duties governed by a contract, Delaware courts will be most reluctant to alter the negotiated terms by invoking fiduciary duties or looking to the implied covenant of good faith and fair dealing. The Court of Chancery has now made it clear that in the case of LLC operating agreements, instruments governing the rights of preferred shareholders and, most recently, employee stock plans, the terms of a contract are supreme. As such, Delaware courts will be loathe to change parties’ bargained-for rights by resorting to extra-contractual duties or obligations.

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