

Milbank

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# Corporate Governance Group Client Alert

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## DELAWARE COURT OF CHANCERY FINDS A “GENUINE ISSUE OF MATERIAL FACT” IN CONNECTION WITH A CLAIMED BREACH OF THE IMPLIED COVENANT OF GOOD FAITH AND FAIR DEALING IN A MERGER AGREEMENT

As a general matter, the Delaware Court of Chancery is reluctant to invoke the implied covenant of good faith and fair dealing when asked to resolve disputes between the parties to well-drafted, unambiguous contracts. In *Amazon.com v. Hoffman*,<sup>1</sup> for example, the Court dismissed a claimed breach of the implied covenant of good faith and fair dealing, concluding that the implied covenant only “applies when the ‘contract is truly silent with respect to the matter at hand, and only when the Court finds that the expectations of the parties were so fundamental that it is clear that they did not feel a need to negotiate about them.’”<sup>2</sup> On the other hand, as was demonstrated last month in *Lola Cars International Limited v. Krohn Racing, LLC, et al.*,<sup>3</sup> the Court may allow a claim of breach of the implied covenant to survive a motion to dismiss if sufficient facts are alleged to support an inference that one party acted “inappropriately and in bad faith.”<sup>4</sup>

The applicability of the implied covenant to a contractual dispute arose again recently in *Amirsaleh v. Bd. Of Trade of City of N.Y., Inc.*<sup>5</sup> In this case, the Delaware Court of Chancery ruled that a triable issue of material fact existed as to whether the Board of Trade of the City of New York, Inc. (“NYBOT”) exercised in good faith its discretion whether or not to accept a late election form submitted by

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<sup>1</sup> No. 2239-VCN (Del. Ch. June 30, 2008).

<sup>2</sup> For a discussion of the *Amazon* decision, please see our previous Client Alert entitled “Delaware Court Again Rules That Express Contract Terms Prevail In Claims Brought By Preferred Shareholder” (July 15, 2009).

<sup>3</sup> No. 4479-VCN (Del. Ch. November 12, 2009).

<sup>4</sup> For a discussion of the *Lola Cars* decision, please see our previous Client Alert entitled “Delaware Court Of Chancery Refuses To Dismiss Action Seeking Dissolution Of A Deadlocked Joint Venture” (December 9, 2009).

<sup>5</sup> No. 2822-CC (Del. Ch. November 9, 2009).

plaintiff Mahyar Amirsaleh in connection with the acquisition of NYBOT by IntercontinentalExchange, Inc. (“ICE”). In so ruling, the Court noted that the implied covenant “is particularly important ... in contracts that defer a decision at the time of contracting and empower one party to make that decision later. In such cases, the discretion-exercising party must exercise its discretion in good faith.”

### *Background*

In December 2006, NYBOT and ICE entered into an Agreement and Plan of Merger pursuant to which NYBOT was to become a wholly-owned subsidiary of ICE. Prior to the merger, which was completed on January 12, 2007, ownership in NYBOT was represented by membership interests, each of which included a right to trade on the NYBOT exchange. Under the terms of the merger agreement, each NYBOT member was given the option to elect to receive, in exchange for each membership interest in NYBOT, either \$1,074,719 in cash, 17,025 shares of ICE common stock or a combination thereof. However, ownership of at least 3,162 shares of ICE common stock was required in order for a former NYBOT member to be able to continue to trade on the NYBOT exchange post-merger.

The merger agreement fixed the aggregate amount of cash and shares payable in the merger, and provided that if either the cash portion or the stock portion of the merger consideration was oversubscribed, the available consideration would be reallocated on a pro rata basis. Any member who failed to make a timely election would receive whatever type of consideration was undersubscribed. The agreement also gave the two companies discretion to fix the deadline for elections. On December 16, 2006, election forms were mailed to all NYBOT members, together with pledge agreements which any NYBOT member electing ICE stock was required to submit along with such member’s election form. The election form specified January 5, 2007 as the deadline for making a timely election.

Prior to the merger, Amirsaleh owned two membership interests in NYBOT. Earlier in December, prior to the mailing of the election forms and pledge agreements by NYBOT, Amirsaleh contacted the Director of Member Services at NYBOT to inquire about receiving the forms. He was told that they would be mailed shortly. Although Amirsaleh did not receive these materials, he neglected to follow up with NYBOT. As a result, Amirsaleh failed to make a timely election.

In the period immediately following the January 5th deadline, NYBOT’s Member Services Department tracked those members who had failed to submit a pledge agreement. On January 12th, Member Services contacted Amirsaleh to alert him that his pledge agreement had not been received. The missing election form was not mentioned by either party on this call. Member Services then faxed a pledge agreement to Amirsaleh, which he signed and returned on January 18th. At that time, Amirsaleh asked Member Services if anything further was required to complete his election. Member Services referred Amirsaleh to the election form, but indicated that it could not guarantee that a late-filed election form would be accepted. Nevertheless, Amirsaleh completed the election form, electing to receive ICE stock, and returned it the following day, January 19th. Even though it had accepted late election forms received through January 18th from other members, NYBOT refused to accept Amirsaleh’s election on the ground that it had not been timely made. Because the stock portion of the merger consideration was oversubscribed, Amirsaleh (like other non-electing members) received only cash in the merger, and thereby faced losing his right to trade on the NYBOT exchange post-merger. Moreover, the amount of the cash consideration was “substantially lower” than the value of the stock consideration at the time of the merger.

Amirsaleh filed suit, alleging that NYBOT breached both the merger agreement and its implied covenant of good faith and fair dealing, and sought an order requiring NYBOT to honor his stock election and to reinstate his two trading memberships. In support of his claim, Amirsaleh contended that NYBOT decided to accept late forms to accommodate only so-called “connected” members and, once all of these members’ forms were submitted by 7:38 p.m. on January 18th, NYBOT closed the late election window. NYBOT responded that it had followed a process “driven solely by valid business considerations,” and the late election window was “held open as long as possible but was closed when it became apparent that the remaining time before January 29 was needed to prepare the merger consideration payout.”

### *The Court’s Analysis*

Chancellor Chandler concluded that NYBOT had not technically breached the merger agreement because, in accepting late elections, it was merely exercising the discretion provided to it under the merger agreement. However, the Chancellor found that “a genuine issue of material fact” existed with respect to Amirsaleh’s claim that NYBOT had breached the implied covenant, and refused to grant summary judgment on that aspect of Amirsaleh’s complaint.<sup>6</sup>

The Court initially observed that breach of the implied covenant “implicitly indicates bad faith conduct.” Amirsaleh contended, however, that a showing of bad faith is unnecessary to establish a breach. Rather, “all that need be shown is an absence of good faith.” Citing recent rulings, Chancellor Chandler rejected this approach, concluding that “there is no meaningful difference between ‘a lack of good faith’ and ‘bad faith.’” Accordingly, to prove a breach of the implied covenant plaintiff must demonstrate that defendants acted in ‘bad faith.’” This, in turn, required that Amirsaleh demonstrate that NYBOT’s conduct “was motivated by a culpable mental state ... or driven by an improper purpose.”

As part of this inquiry, the Court considered whether the manner in which NYBOT exercised its discretion “conflicted with the reasonable expectations” of the parties to the merger agreement. This required an examination of “what conduct the Merger Agreement Parties would clearly have agreed to proscribe had they foreseen it.”

The Court began this analysis by noting that no claim would exist if NYBOT had declined to accommodate late elections altogether, and that any “general efforts ... to accommodate all late elections would rightly be viewed as *exceeding* the implied covenant’s requirements.” On the other hand, the Court reasoned, the parties would “not have agreed to provide preferential treatment to connected members who failed to make their elections by the election deadline ... because common notions of fair dealing dictate that affording such preferential treatment to connected members would be inappropriate.” On this basis, the Court found that NYBOT was “subject to an implied contractual obligation not to make a discretionary decision to accept late forms solely based on the fact that certain connected members had failed to turn their forms in on time.” Such conduct, if it occurred, “would plainly amount to bad faith.”

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<sup>6</sup> The Chancellor also determined that Amirsaleh had standing to bring this action on the basis that he “had standing as a third-party beneficiary to enforce portions of the Merger Agreement.”

The Court concluded by noting that the motivation underlying NYBOT's conduct was a disputed issue of material fact to be determined at trial. Accordingly, the motion for summary judgment before the Court was denied. The Court did note, however, that even if it could be shown that NYBOT's "general efforts to accommodate late comers were disorganized, disjointed, or less than optimal," such a showing would not be sufficient to demonstrate breach of the implied covenant of good faith and fair dealing absent a showing of "wrongful intent."

### *Conclusion*

The *Amirsaleh* decision demonstrates that, however reluctant the Delaware courts may be to utilize the implied covenant of good faith and fair dealing in resolving a contractual dispute, they are willing to intervene on this basis, even in the absence of a direct contractual breach, when specific and credible allegations of bad faith are present. This will be particularly true where the contract defers actions until a later date, and bestows unfettered discretion on one of the parties to act. And even though impacted equity owners may not be actual parties to a business combination contract such as a merger agreement, the courts will extend them third party beneficiary rights to enforce the implied covenant under appropriate circumstances.

Please feel free to discuss any aspect of this Client Alert with your regular Milbank contacts or with any of the members of our Corporate Governance Group, whose names and contact information are provided below.

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