manatt

May 13, 2008

M&A LAW @MANATT
NEWSLETTER OF THE MERGERS & ACQUISITIONS PRACTICE GROUP OF MANATT, PHELPS & PHILLIPS, LLP

This article was originally published in the March 2008 issue of The M&A Lawyer.

United Rentals Denied Specific Performance, Cerberus Walks: Use of Forthright Negotiator Principle Serves as Cautionary Tale to M&A Professionals

Bruce B. Kelson
David M. Grinberg
Gordon M. Bava

On December 21, 2007, following a two-day trial, Chancellor William B. Chandler III of the Delaware Court of Chancery denied the request of United Rentals, Inc. (URI), for specific performance of its merger agreement with the acquisition entities controlled by private equity firm Cerberus Capital Management, L.P. (Cerberus). Chancellor Chandler held that specific performance was not an available remedy under the merger agreement, and therefore URI could not compel the Cerberus acquisition entities to complete the acquisition, leaving collection of the $100 million reverse termination fee as the only remedy available to URI.

The URI/Cerberus dispute is one of the more recent of the numerous abandoned or "broken" deals in the wake of the disruption in the credit markets beginning in the summer of 2007. Unlike most of the other disputes, however, Cerberus never asserted that URI had suffered a material adverse change, and in fact, Cerberus even acknowledged its belief that URI had not suffered a material adverse change since the execution of the merger agreement. Rather, citing its unwillingness to force its lenders to commit funds in a considerably less favorable environment, Cerberus stated simply that it did not intend to proceed with the acquisition on the terms contemplated by the merger agreement. As Chancellor Chandler noted, "the dispute between URI and Cerberus is a good, old-fashioned contract case prompted by

NEWSLETTER EDITORS

David Grinberg
Partner
dgrinberg@manatt.com
310.312.4238
Matthew S. O'Loughlin
Associate
moloughlin@manatt.com
714.338.2710

buyer's remorse."

The URI/Cerberus dispute centered on whether the merger agreement limited URI's remedy to the $100 million reverse termination fee, or whether URI could seek specific performance and compel Cerberus to complete the transaction. In its ruling, the court stated that three challenges existed to URI's contention that specific performance should be granted. First, the language of the merger agreement was ambiguous due to the direct conflict between two provisions regarding the availability (or nonavailability) of specific performance. Second, the court held that extrinsic evidence of the negotiation process was inconclusive and "too muddled" to reflect any "common understanding of the parties" on the issue. Finally, relying on the "forthright negotiator principle" of contract interpretation, the court interpreted the merger agreement to exclude specific performance on the grounds that Cerberus had a clear and forcefully communicated subjective understanding that specific performance would not be available to URI, that URI knew or should have known of this understanding, and that Cerberus had no reason to know of any contrary understanding on URI's part because URI had failed to communicate to Cerberus any such contrary understanding.

The court's ruling serves as a cautionary tale as to the eternal importance of clear, unambiguous drafting of contractual terms, especially with respect to legal remedies and other "back of the agreement" provisions that may not typically be the focus of negotiations regarding deal terms. The ruling also underscores the importance of communicating intentions and understandings with respect to key contractual terms, and the less obvious importance of addressing and "hashing out" any contrary intentions and understandings that may be voiced by opposing counsel. In the event that contractual language turns out to be less than crystal clear on one or more issues, and where parol evidence of the negotiation process also suggests no common understanding of the parties, then the forthright negotiator principle may provide a tertiary basis for resolving contractual disputes. Accordingly, unless the terms of an agreement are unmistakably clear (and that may rarely be the case, especially in hindsight), contrary interpretations of key provisions as advanced by opposing counsel should never be suffered in silence.

Background – A "Deeply Flawed Negotiation"

On July 22, 2007, URI executed a merger agreement with two Cerberus-controlled shell entities, RAM Holdings, Inc., and RAM Acquisition Corp., contemplating the acquisition of URI by the RAM entities for $34.50 per share in cash. The total equity value of the transaction was approximately $4 billion and the total enterprise value was approximately $7 billion, including the repayment or refinancing of URI's existing debt. The merger agreement provided for a reverse termination fee of $100 million, payable by the RAM entities to URI under certain conditions, including if the RAM entities decided to "walk away" from the merger agreement.

Because the RAM entities were shell entities that essentially had no assets, in conjunction with the execution of the merger agreement, URI entered into a limited guarantee with a separate Cerberus affiliate (Cerberus Partners, L.P.) to ensure that there would be financial backing accessible to URI for the shell entities' obligations under the merger agreement. As the court stated in its opinion, the execution of such a guarantee is "market practice" in leveraged buyout transactions sponsored by private equity firms. Under the guarantee, Cerberus Partners was responsible for the payment obligations of the RAM entities (including the reverse termination fee) up to a maximum amount of $100 million plus certain solicitation expenses.

In addition, Cerberus itself entered into an equity commitment letter with the RAM entities, in which Cerberus agreed to provide not less than $1.5 billion in equity financing to the RAM entities in connection with the transaction. Notwithstanding URI's efforts to have it named as a third-party beneficiary under the equity commitment letter, the equity commitment letter explicitly excluded URI as a third-party beneficiary.

On May 18, 2007 (following its exploration of various strategic alternatives to maximize shareholder value), URI sent an initial draft merger agreement to various potential buyers, including Cerberus. Over the course of the next two months, URI, with the assistance of its legal counsel and financial advisors, negotiated the terms of the merger agreement and related documents with Cerberus. In its opinion, the court criticized this process as a "deeply flawed negotiation in which both sides failed to clearly and consistently communicate their client's positions."

The initial draft of the merger agreement delivered by URI to the potential buyers contained "seller-friendly" provisions, including (i) URI's right to specifically enforce the merger agreement, (ii) a broadly worded guarantee on the part of the private equity sponsor, and (iii) URI's right to specifically enforce the terms of the equity commitment letter in order to require the acquisition entities to complete the equity financing and consummate the merger. The initial draft also contemplated a requirement that the acquisition entities take enforcement actions against the lenders in order to consummate any debt financing.

Through its markup of the initial draft, Cerberus countered with "buyer-friendly" terms and removed all references to the proposed guarantee as well as all provisions empowering URI to enforce the equity commitment letter and requiring the RAM entities to take action against its lenders. In addition, Cerberus deleted the specific performance provision in the merger agreement. During the trial, URI's counsel testified that he acknowledged to the RAM entities' counsel during the negotiation that the right of specific performance against the buyer was "off-market," but that a right to specifically enforce the merger agreement was very important to URI, in order to ensure that the RAM entities would close the transaction if the financing was available.

Over the following two months, the parties went back and forth negotiating these terms as well as others. In subsequent drafts of the merger agreement, URI attempted to restore the provisions allowing URI to seek specific performance of the merger agreement and the equity commitment letter and requiring the RAM entities to take action against the lenders to compel them to fund the transaction. URI also proposed a more limited guarantee by Cerberus to cover the obligation of the RAM entities to pay the reverse termination fee.

Cerberus' responses indicated a willingness to reconsider its position as to a limited guarantee. However, the responses rejected the inclusion of any language that would have permitted URI to seek specific performance of the merger agreement or the equity commitment letter or that would have required the RAM entities to take action against the lenders.

Almost two months into the negotiations, a draft of the merger agreement was circulated that included the two key provisions that Cerberus would argue at trial demonstrated that URI had agreed that its sole and exclusive remedy against Cerberus would in all circumstances be limited to recovery of the reverse termination fee and that Cerberus would have no obligation beyond payment of that fee in the event that it decided not to go forward with the transaction.

The Final Merger Agreement – Contradictory Provisions Regarding Availability of Specific Performance

Following lengthy negotiations, the final merger agreement contained the following two critical, and apparently contradictory, provisions at issue.

First, Section 9.10 (Specific Performance) provided that

> The parties agree that irreparable damage would occur in the event that any of the provisions of this Agreement were not performed in accordance with their specific terms or were otherwise breached. *Accordingly, . . . (b) the Company shall be entitled to seek an injunction or injunctions to prevent breaches of this Agreement by [RAM] or to enforce specifically the terms and provisions of this Agreement and the Guarantee to prevent breaches of or enforce compliance with those covenants of [RAM] that require [RAM] to (i) use its reasonable best efforts to obtain the Financing and satisfy the conditions to closing . . . and (ii) consummate the transactions contemplated by this Agreement*, if in the case of this clause (ii), the Financing . . . is available to be drawn down by [RAM] pursuant to the terms of the applicable agreements but is not so drawn down solely as a result of [RAM] refusing to do so in breach of this Agreement. *The provisions of this Section 9.10 shall be subject in all respects to Section 8.2(e) hereof, which Section shall govern the rights and obligations of the parties hereto (and of [Cerberus and related parties] and the Company Related Parties) under the circumstances provided therein.*

Second, subsection (e) of Section 8.2 (Effect of Termination) provided that

> Notwithstanding anything to the contrary in this Agreement, including with respect to Sections 7.4 and 9.10, (i) the Company's right to terminate this Agreement in compliance with the provisions of Sections 8.1(d)(i) and (ii) and its right to receive the Parent Termination Fee pursuant to Section 8.2(c) or the guarantee thereof pursuant to the Guarantee . . . shall . . . be the sole and exclusive remedy . . . of . . . the Company and its subsidiaries against [RAM, Cerberus or related parties] . . . for any and all loss or damage suffered as a result thereof. . . . *In no event, whether or not this Agreement has*

been terminated pursuant to any provision hereof, shall [RAM, Cerberus or related parties], either individually or in the aggregate, be subject to any liability in excess of the Parent Termination Fee for any or all losses or damages relating to or arising out of this Agreement or the transactions contemplated by this Agreement, including breaches by [RAM] of any representations, warranties, covenants or agreements contained in this Agreement, and in no event shall the Company seek equitable relief or seek to recover any money damages in excess of such amount from [RAM, Cerberus or related parties] or any of their respective Representatives.

Repudiation and Litigation

On November 14, 2007, in the wake of further turbulence in the credit and financial markets, Cerberus informed URI that it was not prepared to proceed with the acquisition on the terms contemplated by the merger agreement. However, Cerberus did not claim that URI had suffered a material adverse change, but rather simply suggested that the decision not to go forward with the transaction was in large part due to its aversion to forcing its lenders to commit funds in a considerably less favorable environment, a decision for which the court criticized Cerberus in its opinion. Cerberus further indicated that it was willing either to engage in a constructive dialogue to explore a transaction on revised terms, or to arrange for payment of the $100 million termination fee.

URI rejected the Cerberus offers to "re-cut" the deal or pay the reverse termination fee and walk away. On November 19, URI filed a lawsuit in Delaware Chancery Court seeking to compel the closing of the acquisition through specific performance of the merger agreement.

Finding of Ambiguity in the Merger Agreement and Resolution Following Trial

Chancellor Chandler's opinion opened with a characteristically learned and colorful introduction in which he compared Hercules' battle in Hades with the beastly three-headed dog Cerberus, the guardian of the gates of the underworld, to URI's battle with the modern-day Cerberus in Delaware. Instead of three heads, the modern-day Cerberus presented three obstacles to the consummation of the merger. Unfortunately, unlike Hercules, who was able to subdue the three heads of the mythological Cerberus, URI could not overcome the "three substantial challenges" presented by the private equity firm. In this case, the language of the merger agreement, evidence of negotiations between the parties and a doctrine of contract interpretation known as the forthright negotiator principle proved too much to overcome.

The court found that the language of the merger agreement was ambiguous because the differing interpretations of URI and the RAM entities were *both* reasonable. In other words, neither interpretation was the *only* reasonable interpretation as a matter of law.

URI argued that the plain and unambiguous language of Section 9.10(b) authorized it to seek specific performance to compel the RAM entities to make reasonable best efforts to obtain financing and to consummate the transaction if the financing is available. URI further argued that this right existed in spite of Section 8.2(e) because (i) the reverse termination fee operated as the "sole and exclusive" remedy only in the event that a party terminated the merger agreement, which had not happened, and (ii) the bar on "equitable relief" was limited to equitable remedies that involved monetary compensation like restitution or rescission, because the term "equitable relief" was modified by the subsequent term "in excess of such amount" (*i.e.*, in excess of the reverse termination fee), and, as a result, specific performance was not barred. Indeed, the court found URI's interpretation to be a reasonable one.

On the other hand, the RAM entities argued that Section 9.10 was expressly made "subject to" Section 8.2(e), which prohibited URI from seeking any form of equitable relief (including specific performance) under all circumstances, leaving URI with the reverse termination fee as its sole remedy. The RAM entities further argued that its interpretation used the plain meaning of the phrase "equitable relief" as encompassing specific performance and that such phrase, unlike the following phrase "money damages," was not modified in Section 8.2(e) by the subsequent phrase "in excess of such amount." The RAM entities further argued that Delaware law specifically permitted parties to establish "supremacy and subservience" between provisions, through phrases such as "subject to," even if the terms of the controlling provision conflict with or nullify the other provision. The court noted that the RAM entitles could have simply stricken out clause (b) of Section 9.10, which "would have been superior," but held that an "interpretation of the Agreement that relies on the parties' addition of hierarchical phrases instead of deletion of particular language altogether is not unreasonable as a matter of law." Therefore, the Court also found the RAM entities' interpretation to be a reasonable alternative interpretation.

The court's determination that both interpretations of the merger agreement were reasonable led the court to conclude that the merger agreement was ambiguous as to whether the parties had agreed that specific performance was intended to be an available remedy.

Because of the ambiguous nature of the words of the merger agreement, the court reviewed the extrinsic evidence (documents and testimony) presented at trial, including the drafting and negotiating history of the merger agreement, equity commitment letter and limited guarantee. Based on the extrinsic evidence, the court was unable to conclude that there was a single, shared understanding with respect to the availability of specific performance under the merger agreement.

The merger agreement simultaneously purported to provide and preclude the specific performance remedy, and was "decidedly ambiguous," and although the RAM entities modified Section 8.2(e) to try to limit the availability of equitable relief, Section 9.10 continued to speak of URI's right to specific performance. The court noted that the testimony revealed that "communications between the parties routinely skirted the issue of equitable relief and only addressed it tangentially or implicitly." The court further noted that the RAM entities had put forth some evidence suggesting that midway through the negotiations URI's counsel had agreed to give up specific performance, but the evidence on that point was not conclusive.

Unable to come to an "obvious, objectively reasonable conclusion" after examining the extrinsic evidence, the court applied the "forthright negotiator principle" to determine the proper interpretation of the merger agreement. This principle "provides that, in cases where the extrinsic evidence does not lead to a single, commonly held understanding of a contract's meaning, a court may consider the subjective understanding of one party that has been objectively manifested and is known or should be known by the other party." In other words, the court "considers the evidence of what one party subjectively believed the obligation to be, coupled with evidence that the other party knew or should have known of such belief."

With respect to URI, the court found that even if URI understood the merger agreement to provide a specific performance remedy, the RAM entities did not know and had no reason to know of this understanding. The court specifically found that even if URI believed the merger agreement preserved a right to specific performance, its counsel "categorically failed to communicate that understanding to [the RAM entities] during the latter part of the negotiations," despite having numerous opportunities to do so.

With respect to the RAM entities, the court found that they understood the merger agreement to bar specific performance and that URI either knew or should have known of this understanding. Although the RAM entities could easily have avoided the entire dispute by striking Section 9.10(b), its counsel did effectively communicate to URI on numerous occasions the understanding that the merger agreement precluded any specific performance rights, that the RAM entities had the right to walk away from the transaction, and that URI's sole remedy would be to collect the reverse termination fee.

Evidence presented at trial that the forthright negotiator principle favored the RAM entities included the following:

- In a conference call during the negotiations, URI's counsel apparently indicated that URI was "okay with the contract as written" regarding the specific performance provision. As written, the specific performance provision was subject in its entirety to Section 8.2(e), which, as modified, purported to nullify the right to specific performance altogether.

- According to Cerberus, URI's counsel confirmed on several occasions that receipt of the reverse termination fee would be its "sole and exclusive remedy" if Cerberus failed to close the merger.

- Several days prior to the execution of the merger agreement, the parties met to discuss various open issues. A principal point of discussion at this meeting concerned the size of the break-up fee that Cerberus would have to pay if it chose not to proceed with the merger. At no point in this discussion did URI indicate that this discussion made no sense, in light of the specific performance right. According to certain testimony and evidence, URI indicated instead that it wanted a large break-up fee in light of the ability of Cerberus to walk away from the deal, and that URI was counting on the combination of that fee and the reputational interests of Cerberus as protection against Cerberus electing to walk away.

- After the meeting, the parties' counsel held a series of calls, during which counsel for Cerberus explained that the bar on "equitable relief" would have to be reinserted into Section 8.2(e), in order to reflect the agreement that URI's only remedy in the event that Cerberus did not proceed would be recovery of the reverse termination fee. In response, counsel for URI purportedly stated, "I get it."

- The day before the parties signed the merger agreement a Cerberus officer had a conversation with URI's financial advisors, in which he indicated his view that the RAM entities were purchasing an "option" on URI. The URI financial advisor responded by saying "That's a nonstarter" and "This is not an option," and expressed URI's concerns about the ability of Cerberus to consummate transaction generally. The Cerberus officer expressed his commitment to the transaction, but never backed away from his characterization of the deal as an "option," and URI apparently never followed up on or disputed this point.

From these episodes, the court concluded that (i) the RAM entities did not know or have reason to know that URI believed specific performance was an available remedy under the merger agreement, (ii) URI knew or should have known that the RAM entities believed that specific performance was not to be available, and, (iii) URI failed to clearly and effectively communicate and clarify its belief and position. Therefore, the court denied URI's request for specific performance of the merger agreement stating that although "the language in this merger agreement remains ambiguous, the understanding of the parties does not." The Court noted that "[o]ne may plausibly upbraid Cerberus for walking away from this deal, for favoring their lenders over their targets, or for suboptimal contract editing, but one cannot reasonably criticize the firm for a failure to represent its understanding of the limitations on remedies provided by this Merger Agreement."

Post-Mortem

On December 24, 2007, URI announced that it would not appeal the court's ruling, and would formally terminate the merger agreement, to collect the $100 million reverse termination fee. On December 26, 2007, the RAM entities made payment to URI, and on December 31, 2007, URI's stock closed at $18.36 – just over one-half of the deal price of $34.50.

Conclusions – "Take Aways"

The lessons of the URI/Cerberus dispute are ones that would seem to be simplistic and easy to avoid. Yet in the stressful and emotionally-charged environment often surrounding merger negotiations where billions of dollars are at stake, the seemingly straightforward can sometimes actually be quite hazy. These lessons can be partitioned into two types: those generally relating to contract drafting and those specifically involving merger agreements. With regard to general contract drafting:

- Legal remedies and other "back of the agreement" provisions can be critically important.

- Reliance on "hierarchical" drafting constructs, using phrases such as "subject to" and "notwithstanding" to control or even nullify other phrases, may be technically acceptable but can leave significant ambiguities. If a provision is nullified or rendered meaningless by such a phrase, it should be deleted altogether, to avoid ambiguity. The case could have been avoided in its entirety if the RAM entities had insisted on the elimination of the specific performance provision or if URI had refused to include language that strongly suggested that the specific performance right was a limited one.

- Ambiguities in a contract may shift the focus to negotiations and understandings of the parties. Taking notes of points that support your positions can be very helpful here. To the extent that they simply record nonprivileged conversations (and do not reflect legal advice or attorney mental impressions), such notes will be discoverable evidence.

- Unless you are certain that a contract is unambiguous, make your intentions and understandings of key provisions known to opposing counsel – and do not ignore contrary views expressed by opposing counsel – because the forthright negotiator principle may be applied. In this context, biting your tongue can cook your goose.

- There is an affirmative duty to clarify your position during negotiations, in particular "in the face of an ambiguous contract with glaringly conflicting provisions." If you are unwilling to confront deal terms directly, you risk letting a court decide who the better communicator is.

- As the Court acknowledged, "parties often riddle their agreements with a certain amount of ambiguity in order to reach a compromise." As this case indicates, however, this approach carries a measure of risk, especially where the stakes are high.

More specifically relating to merger agreements:

- Carefully consider the interaction between reverse termination fees, exclusive remedy provisions, and specific performance provisions and what events trigger the payment of the reverse termination fee in light of other remedies that the parties intend to preserve. If the parties intend the merger agreement to be an option agreement, the merger agreement should clearly specify that the target's only remedy prior to the closing is the reverse termination fee and there is no right to compel the buyer to close the transaction. On the other hand, if the parties agree that the target has the right to force the buyer to use reasonable best efforts to obtain and draw down financing to close the transaction, the merger agreement should expressly allow the target to specifically enforce these covenants and provide that the reverse termination fee is only applicable when the buyer is not in breach of its obligations under the merger agreement.

- If the parties intend that they can specifically enforce the agreement, they need to clearly provide for that remedy, and should also ensure that the subject company is a direct beneficiary under equity commitments and can force the acquisition vehicles to draw down on financing sources.

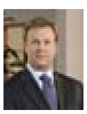
The lasting effects of the URI/Cerberus quarrel remain to be seen. Certainly, targets should be more vigilant in the negotiation of their remedies in situations where private equity buyers may simply abandon ship and voluntarily choose not to close the transaction.

But do the URI/Cerberus dispute and its outcome debunk the popular notion that the combination of a reverse termination fee obligation and potential damage to its hallowed reputation serve as adequate protection against private equity firms electing to walk away from transactions? That remains uncertain, but is perhaps unlikely. As some commentators have noted, the majority (or all) of the more recently announced private equity transactions do not provide for any form of specific performance or "recourse," and instead embody a "pure" reverse termination fee (or "pure option") model, under which targets continue to rely exclusively on the private equity buyer's reputational interests, and on the compensation reflected in the reverse termination fee, for protection. (In any event, sellers in private equity transactions are now likely much better off than they were just a few years ago, when the prevailing buyout model included "financing out" conditions that provided sellers with neither certainty nor any meaningful compensation in the form of reverse termination fees.) If this model continues to prevail, targets may eventually seek larger reverse termination fees to offset the new reality and to make up for their inability to obtain meaningful rights to specific performance.

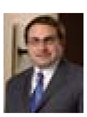
Besides price, deal certainty is the most important term of a transaction. Therefore, perhaps a longer term result will be an increasing number of transactions with strategic buyers as opposed to private equity firms, since agreements with strategics generally do not contain restrictions on a target's ability to seek specific performance. In light of the dearth of leverage currently available due to the so-called "credit crunch," strategic buyers have already started to become more active in the M&A arena. The allure of deal certainty, in the form of specific performance rights, may hasten their return.

back to top

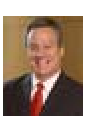
FOR ADDITIONAL INFORMATION ON THIS ISSUE, CONTACT:



Bruce B. Kelson Mr. Kelson's practice focuses on securities litigation and other complex commercial litigation for U.S. and foreign clients. He represents and advises clients in connection with securities class action and shareholder derivative litigation, internal investigations, SEC and other regulatory proceedings, transaction-related issues and litigation, director and officer liability and corporate governance issues and litigation, antitrust and unfair competition litigation, and other commercial litigation. Mr. Kelson has extensive experience in federal and state courts and arbitral forums in California, New York, Delaware and other states.



David M. Grinberg Mr. Grinberg's practice focuses on mergers and acquisitions, including tender offers, proxy contests, hostile takeovers and special committee representation, and underwritten securities offerings, including initial public offerings and public and private offerings of equity and debt.



Gordon M. Bava Mr. Bava is Co-Chairman of the Firm after serving for a decade as its Chief Executive and Managing Partner until December 31, 1999. Mr. Bava's practice focuses on mergers and acquisitions, special committee representation, private and underwritten securities offerings and general corporate representation of clients in a variety of industries.