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by David Leinwand and Victor Goldfeld

A recent decision by the Delaware Court of Chancery arising out of the aborted buyout of United Rentals by Cerberus offers several important lessons for the M&A practitioner. In its wake, targets and financial sponsors are likely to reconsider the reverse break-up fee, specific performance, equity commitment and related provisions in leveraged buyout documentation in the quest to balance the desire of targets for increased certainty of closing with the desire of financial sponsors for clear limitations on liability.

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In a simpler time, not so long ago, when a financial sponsor and a public target agreed to a leveraged buyout, the transaction agreement would typically include a debt financing condition to the sponsor's obligation to close. The sponsor would be required to consummate the transaction only if it obtained the financing described in its debt commitment letter or was able to procure substitute financing on terms not materially worse for the sponsor. The sponsor would agree to use its efforts to complete the debt financing, and the target would agree to cooperate in those efforts. It was all quite straightforward really. Assuming the satisfaction of the other conditions to the transaction, there would be a closing if the debt financing showed up. It was taken as a given that no bank would risk its reputation by reneging on, or attempting to renegotiate, the promised financing. Targets took further comfort in the belief that a financial sponsor would be unwilling to risk its reputation by failing to use best efforts to obtain debt financing and close a deal.

Then came the sale on money. Financial sponsors were flush with more equity than they could put to work, and banks were willing to lend quite cheaply. Ironically though, coffers swollen beyond their wildest dreams with equity and debt financing led, in many circumstances, to less negotiating leverage for financial sponsors. For every decent public target up for sale, there was a host of interested suitors with plenty of money to spend. Targets could negotiate higher prices and better terms. Flexing their new muscles, some target boards, seeking greater certainty of closing, informed potential suitors that including the once-common debt financing condition would put a bid at a significant disadvantage to its many, many competitors for the deal.

Times were good, but transactions became more complicated. The removal of the simple debt financing condition created a variety of novel deal issues, and leveraged buyout agreements became increasingly complex. One major issue was what would happen in the event the sponsor's committed debt financing failed. Receipt of the debt financing would not be a condition to a sponsor's obligation to close, but at the same time, sponsors were not eager to be on the hook for a multi-billion dollar deal if it turned out they couldn't raise the necessary debt. As a result, the reverse break-up fee made its appearance, payable by the sponsor, and serving as a limit on the sponsor's total liability, in the event the debt financing failed. In the course of many negotiations, sophisticated sponsors sought to extend the limit on liability to any circumstance, not just if the debt financing failed. Some sponsors succeeded in this regard, and negotiated agreements allowing them to walk away from a transaction for any reason with payment of the reverse break-up fee.

The old saying is that the devil—or the angel, depending on your perspective—is in the details. And it is in the details of the complex guarantee, equity commitment letter, termination, reverse break-up fee and specific performance provisions that arose to replace the simple financing condition that one finds the answer to the question of whether a

particular target really achieved its goal of greater certainty of closing by insisting on the removal of the good old financing condition and accepting the reverse break-up fee architecture.

The story does not have a happy ending for some. Times changed again. In the summer of 2007, the sale on money came to an abrupt end, and it was no longer so clear that banks and sponsors would be unwilling to risk their reputations by walking away from or attempting to renegotiate signed transactions. As debt got more expensive and banks became skittish, many pending transactions got ugly, putting the new complex reverse break-up fee construct to the test. One version of the new deal architecture recently was tested in the Delaware Court of Chancery as a result of the aborted buyout of United Rentals by Cerberus.[1] United Rentals sought to cause Cerberus to complete the transaction, and was told by the court that it would not be entitled to compel Cerberus to close regardless of whether Cerberus could access the necessary financing. In the end, from the perspective of that target, replacement of the debt financing condition with the new reverse break-up fee structure clearly did not provide the hoped-for increased certainty of closing.

The *United Rentals* Case

In May 2007, United Rentals, Inc. ("URI"), the largest equipment rental company in the world, put itself up for auction. Following an intense and lengthy negotiation, in July 2007, financial sponsor Cerberus agreed to buy URI for $34.50 per share in cash, a total transaction value of approximately $7 billion. On November 14, 2007, in the wake of the subsequent turmoil in the credit markets, Cerberus notified URI that it would not proceed with the acquisition on the previously agreed terms, but would be willing to either pay URI the $100 million reverse break-up fee specified in the merger agreement or attempt to renegotiate the terms of the deal.[2]

URI responded by filing a suit in the Delaware Court of Chancery claiming it was entitled to compel the closing of the deal under the terms of the merger agreement. Reading the same agreement, Cerberus countered that the merger agreement allowed it to walk away from the transaction for any reason with its total liability limited to the amount of the reverse break-up fee.

In many respects, the merger agreement and related documentation in the URI deal were typical of recent leveraged buyout transactions:

- The merger agreement did not include a financing condition, and instead provided for a $100 million reverse break-up fee that limited the acquiror's liability in certain circumstances.
- The merger agreement was signed by the target (URI) and two shell entities—RAM Holdings, Inc. and RAM Acquisition Corp.—that were established by Cerberus for the purpose of the transaction.
- In order to give URI comfort that there were assets backing up the RAM entities' obligations under the merger agreement, the sponsor's fund itself—Cerberus Partners, L.P.—signed a "limited guarantee" in favor of URI. However, the limited guarantee contained important limitations on URI's ability to obtain recourse thereunder, including provisions (a) capping Cerberus Partners' liability to $100 million plus certain solicitation expenses and (b) making recourse against Cerberus Partners under the limited guarantee the sole and exclusive remedy of URI against Cerberus Partners in connection with the merger agreement.

- The sponsor's management company—Cerberus Capital Management, L.P.—signed an "equity commitment letter" in favor of RAM Holdings obligating it to contribute $1.5 billion of equity capital subject to the satisfaction of certain conditions. URI was not a party to this letter, which included an express disclaimer of third-party beneficiary rights, as well as language requiring any claims under the merger agreement or equity commitment letter to be made only pursuant to the limited guarantee.

There were, however, ambiguities and contradictions in the lengthy and complex reverse break-up fee and specific performance provisions in the merger agreement. Specifically, it was unclear whether the reverse break-up fee was the only remedy available to URI in circumstances in which the Cerberus entities chose simply to walk away from the transaction (regardless of the reason) or whether URI might have the right to require the RAM entities to attempt to access the financing and close.[3] The specific performance section of the merger agreement contained language suggesting that URI could compel RAM to consummate the merger in certain circumstances. On the other hand, the reverse break-up fee section of the merger agreement contained language suggesting that URI was not entitled to equitable relief compelling RAM to close the transaction.

URI moved for summary judgment, seeking an order specifically enforcing the merger agreement. In arguing that motion, each of Cerberus and URI sought to persuade the court that its interpretation of the conflicting provisions in the merger agreement was the only reasonable one. URI contended that the relevant provisions granted URI a right of specific performance against RAM if RAM's financing was available. RAM responded that the reverse break-up fee of $100 million was the "sole and exclusive remedy" of URI on account of losses relating to termination of the merger agreement, and that the agreement precluded URI from seeking equitable relief altogether. Each side maintained that the other's argument would render certain contractual language meaningless and therefore was untenable.

In considering the summary judgment motion, the court waded into the merger agreement's thicket of subject-to's and notwithstanding-anything-to-the-contrary's and considered the parties' nuanced, technical legal arguments regarding their interpretation. Despite the heroic efforts of counsel, Chancellor Chandler concluded that the agreement was muddled and neither party had demonstrated that its interpretation of the merger agreement was "the *only* interpretation of the Agreement that is reasonable as a matter of law."[4] As a result, summary judgment was inappropriate, and a trial was held to consider extrinsic evidence to ascertain the meaning of the relevant provisions.

The court heard lawyers, bankers and principals describe their tortuous negotiations under oath, reviewed notes taken by the participants, and carefully examined the numerous draft agreements exchanged by the parties to determine the evolution of the transaction documentation. After this exercise, the Chancellor not surprisingly found that the extrinsic evidence presented at trial was not clear enough to conclude that there was a single, shared understanding of the "[h]opelessly [c]onflicted" provisions with respect to Cerberus' ability to walk away by paying the reverse break-up fee or URI's right to obtain specific performance. The court then

turned to the "forthright negotiator" principle. Under that doctrine, "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."[3]

The court found that, early in the negotiation, URI did in fact communicate that "the deal was supposed to be that if the financing was there . . . the RAM entities should have to access the financing and close the transaction."[6] But in the course of negotiation, URI appeared to move off that position. As one Cerberus managing director explained at trial, by the end of the process he believed "there was an explicit understanding that Cerberus could choose not to close the transaction for any reason or no reason at all and pay a maximum amount of a hundred million dollars."[7] The Chancellor agreed and found that Cerberus understood the agreement to preclude specific performance even if financing was available, and URI either knew or should have known of this understanding. As the court explained, by the time the merger agreement was signed, "URI knew or should have known what Cerberus's understanding of the Merger Agreement was, and if URI disagreed with that understanding, it had an affirmative duty to clarify its position in the face of an ambiguous contract with glaringly conflicting provisions."[8] Having failed to do so, under the forthright negotiator principle, URI was barred from obtaining specific performance of the merger agreement. The reverse break-up fee would be its only remedy.

Some Lessons of *United Rentals*

Clarity in Drafting

Perhaps the starkest lesson of *United Rentals* is the importance of reaching a clear agreement on key contractual issues and documenting it accordingly. Whatever the parties in *United Rentals* actually understood the merger agreement to provide with respect to the availability of a specific performance remedy or the ability of Cerberus to walk away, the agreement itself was unclear. For example, had the parties intended to preclude URI from obtaining specific performance, they could have used language similar to that used in the recent buyout of Alltel Corporation by TPG Capital and GS Capital Partners:

> The parties acknowledge and agree that neither the [Target] nor any of its Subsidiaries shall be entitled to an injunction or injunctions to prevent breaches of this Agreement or to enforce specifically the terms and provisions of this Agreement and their sole and exclusive remedy with respect to any such breach shall be the monetary damages set forth in Section 7.2(b) [*which provided for payment of a "Parent Termination Fee" in certain circumstances*].

Of course, there may be any number of reasons why the parties in *United Rentals* did not agree to such unambiguous language. URI's counsel may have understood that they had lost the point as a business matter and made a tactical decision not to further contest RAM's proposed language (from URI's perspective, an agreement that was ambiguous with respect to the availability of specific performance would be better than an agreement that clearly denied it);[9] for tactical reasons, counsel for Cerberus may simply have decided the language was

clear enough and it would not be helpful to focus further on the point; or the parties may in fact have felt that the language conveyed their understanding of the business agreement with sufficient clarity. Whatever the reasons it was used, the actual language on the crucial issues of the reverse break-up fee and specific performance was a recipe for litigation.

What You Say (or Don't Say) During Negotiations May Haunt You

United Rentals also provides a reminder that, in the event of litigation, what often matters is not only the terms of the agreement, but also the course of negotiations. Be careful of what you say (and write) in conference rooms at three o'clock in the morning. After finding the contract ambiguous, the court looked in great detail at extrinsic evidence to determine the intentions of the parties, including the statements made by the participants, the various drafts of the transaction agreements and the notes taken by advisors. Parties and advisors should remain mindful that their statements, notes and drafts may one day be attached as an exhibit to a brief or affidavit.

Open Issues With Respect to Forcing Private Equity Buyers to Close

Another important aspect of *United Rentals* is what the court did *not* decide. Because the court concluded that URI was not entitled to specific performance, it did not reach several important issues that may arise in future disputes over the reverse break-up fee architecture in leveraged buyout agreements. If the Chancellor had awarded specific performance, what would have happened next? The RAM entities were merely shells, and could not perform the merger agreement without obtaining equity and debt financing. It is not clear how events would have unfolded with respect to the Cerberus equity commitment, particularly in light of the provisions in the equity commitment letter disclaiming third-party beneficiary rights, and provisions in the limited guarantee and equity commitment letter that purported to make recourse under the limited guarantee against Cerberus Partners the sole and exclusive remedy of URI. Under current conditions, it is possible that the banks may have refused to fund on the basis of a purported material adverse effect or some other failure of a closing condition to the debt financing or insisted on renegotiating the terms. Practitioners should keep in mind that, even if a target could obtain specific performance against a private equity buyer's shell entities, the target still would face significant hurdles to actually completing the transaction.

The Next Big Thing?

Much of the *United Rentals* opinion is devoted to the conflicting contractual provisions, but in the end, the court put them aside and concluded that, in fact, URI had acquiesced to Cerberus' request that it be permitted to walk away from the transaction "for any reason or no reason at all" so long as it paid the reverse break-up fee. In the last couple of years, URI is not the only target to have done so. The irony of course is that targets initially replaced financing conditions with the reverse break-up fee architecture in an effort to increase certainty of closing. In some instances, such as the URI deal, in the course of eliminating the financing condition the target found that it had sold the financial sponsor an option for an unacceptably low price (the "price" of the option being the amount of the reverse break-up fee). Much depends on the price of such an option and the specific terms of the sponsor's equity

commitment, but it seems likely that, in the wake of *United Rentals*, targets will be re-examining their approach to the contingency of financing and the related issues of reverse break-up fees and limitations on buyer liability. On the buy side, financial sponsors also may be taking a closer look at the reverse break-up fee construct. In the event a target determines that the answer to *United Rentals* is a very steep reverse break-up fee, a financial sponsor may not be willing to put that money at risk in light of the disruption in the credit markets and the recent attempts by some financial institutions to renegotiate committed financing. How these competing concerns will be resolved remains to be seen—that is, to the extent there are leveraged deals in the days ahead.

1 *United Rentals, Inc. v. RAM Holdings, Inc.*, — A.2d —, No. 3360-CC, 2007 WL 4496338 (Del. Ch. Dec. 21, 2007).

2 Despite some published reports, Cerberus did not assert that it had the right not to close because of a material adverse effect. *See id.* at *25 n.202.

3 The court's opinion does not give any indication of whether the debt providers were unwilling to provide debt financing on the terms of their debt commitments letters.

4 *United Rentals*, 2007 WL 4496338 at *18.

5 *Id.* at *19.

6 *Id.* at *20.

7 *Id.* at *22.

8 *Id.* at *25.

9 In this regard, it is interesting that the opinion does not discuss how the relevant provisions were described to URI's board of directors.

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