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# Litigation

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## Delaware Court of Chancery Holds That Target May Not Force Private Equity Firm To Proceed with Buyout

**By Robert Hora**

On December 21, 2007, after a two-day trial, Chancellor William B. Chandler III, Chief Judge of the Delaware Court of Chancery, ruled that private equity firm Cerberus Capital Management (“CCM”) was not contractually required to consummate its planned \$7 billion acquisition of equipment rental company United Rentals, Inc. (“URI”), but could instead walk away from the transaction incurring only the obligation to pay a \$100 million breakup fee.<sup>1</sup> See *United Rentals v. RAM Holdings, Inc.*, Civ. A. No. 3360-CC, 2007 WL 4496338 (Del. Ch. Dec. 21, 2007). The URI deal was one of several leveraged buyouts to founder in recent months amid turmoil in the credit markets, and resulted in the first litigation arising out of such a failed buyout to proceed to trial in Delaware. Chancellor Chandler’s decision in *United*

*Rentals*, which turns on a seldom invoked principle of contract interpretation known as the “forthright negotiator” doctrine, illustrates the importance not only of drafting tight provisions on termination and remedies in buyout agreements, but also of open and honest communication by parties in contract negotiations concerning their objectives and their understanding of potentially conflicting or ambiguous contractual provisions.

### The Transaction Agreements

On July 22, 2007, URI entered into an agreement with two shell entities formed by CCM – RAM Holdings Inc. and RAM Acquisition Corp. (together, “RAM”) – pursuant to which the shell entities would merge with and acquire URI for a purchase price of approximately \$4 billion. With assumption of indebtedness by

the buyer, the total value of the transaction was nearly \$7 billion.

As is typical in private equity LBO transactions, CCM, the buyout sponsor, was *not* a party to the merger agreement. Rather, CCM agreed to provide \$1.5 billion in equity financing to RAM under an equity commitment letter (“ECL”) executed between CCM and RAM, subject to conditions set forth in the letter. RAM obtained the balance of the financing for the transaction through debt commitments from four lenders.

The transaction agreements were the subject of intense negotiations, and went through several iterations. As is typically the case, URI prepared a form of merger agreement to serve as a starting point in negotiations. This form was described by its draftsman as “market standard” *except for* non-standard, aggressive provisions that would have afforded URI the

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<sup>1</sup> Milbank represented CCM and its affiliates in the litigation, with assistance from Richards, Layton & Finger P.A. and Shapiro Forman Allen Sava & McPherson LLP.

ability to compel the buyer to close if the buyer's lenders were prepared to fund their debt commitments. This first draft of the merger agreement provided that URI had the right to seek specific performance of the ECL and the right to obtain specific performance against the shell entities to compel those entities to draw down their financing and "consummate the [merger] transactions." The draft also contained a provision requiring RAM to take enforcement action against lenders and financing sources to compel them to fund their commitments. In addition to these protections, URI proposed that CCM execute a separate guarantee providing that URI could bring an action for specific performance of the ECL, and demanded that the ECL name URI as an express third-party beneficiary.

The final agreements show a stark departure from the broad recourse against the sponsor initially proposed by URI. The limited guarantee ultimately executed in favor of URI by Cerberus Partners L.P., an affiliate of CCM, provided that recourse against Cerberus Partners under the limited guarantee for payment of up to \$100 million was URI's "sole and exclusive remedy" against Cerberus Partners and its non-RAM affiliates, including CCM, for any breach of the merger agreement. In addition, the ECL expressly stated that URI was *not* a third-party beneficiary and provided

that "any claims with respect to the transactions contemplated by the Merger Agreement or this Equity Commitment Letter shall be made only pursuant to the [Limited] Guarantee."

The merger agreement's recourse provisions were also substantially altered from URI's original draft. The language pertaining to URI's right of specific performance of the ECL was stricken, as was the provision obligating RAM to pursue enforcement action against the lenders and other financing sources. Although the remaining text of § 9.10 of the merger agreement provided that URI could force RAM to draw down its financing and consummate the merger, § 9.10 in its entirety was made "subject in all respects to Section 8.2(e)" of the merger agreement. Section 8.2(e) provided that "in no event shall [URI] seek equitable relief" against RAM or its affiliates. Based on the addition of this "subject to" language, RAM believed that § 8.2(e) nullified URI's specific performance remedy under § 9.10.

On November 14, 2007, RAM notified URI that it was not prepared to close on the terms contemplated by the merger agreement. RAM offered to renegotiate the transaction or, alternatively, pay the \$100 million termination fee. There was no indication as of this point that the banks that were to provide the debt financing

were unwilling to fund. On November 19, 2007, URI filed suit in the Delaware Court of Chancery seeking to force RAM to complete the merger, arguing that the specific performance language in the merger agreement gave URI the right to force RAM to draw down its equity and debt financing and close the merger.

### **Denial of Summary Judgment**

Given the imminent expiration of the debt commitments, Chancellor Chandler set an expedited trial for December 17, 2007, but also allowed URI to file an expedited motion for summary judgment. In its summary judgment briefing, URI invoked the maxim that a contract should not be read so as to render any term meaningless or nugatory. Seeking to harmonize the claimed grant of a specific performance right under § 9.10 of the merger agreement with § 8.2(e)'s prohibition of equitable relief, URI argued that the only permissible reading of the merger agreement that gave meaning to both provisions was to read § 8.2(e) as barring only equitable remedies that involve affirmative monetary recovery, like rescissory damages or restitution.

RAM countered that URI's reading was not the only facially reasonable reading of §§ 8.2(e) and 9.10. Citing *Penn Mutual Life Insurance Co. v. Oglesby*, 695 A.2d 1146, 1150 (Del. 1997) and *Supermex Trading Co. v. Strategic Solutions*

*Group*, No. Civ. A. 16183, 1998 WL 229530 (Del. Ch. May 1, 1998), RAM argued that Delaware law expressly permits parties to use phrases like "subject to" to subordinate one contractual provision to another, and thereby to render the subordinated provision inoperative in whole or in part. Thus, RAM argued, the merger agreement expressed on its face the parties' agreement that § 8.2(e)'s prohibition upon "equitable relief" in favor of URI meant that the specific performance remedy in § 9.10 was unavailable.

Chancellor Chandler denied URI's summary judgment motion in a brief opinion. In his post-trial decision, Chancellor Chandler explained more fully that while URI's proposed facial interpretation of §§ 8.2(e) and 9.10 was reasonable, RAM's proposed facial interpretation was equally, if not more, reasonable. *United Rentals*, 2007 WL 4496338, at \*37, 41-44 (noting, *inter alia*, that RAM's interpretation gave "equitable relief" its plain meaning). Although RAM's interpretation of the merger agreement would render parts of § 9.10 meaningless, "[a]n interpretation of the [merger] agreement that relies on the parties' addition of hierarchical phrases" like "subject to" instead of "deletion of particular language altogether" was "not unreasonable as a matter of law." *Id.* at \*43. With the

provisions of the merger agreement thus “fairly susceptible to at least two reasonable interpretations,” *id.* at \*37, the Court found that an issue of fact existed for trial: “what was the intent of the parties?” *Id.* at \*44.

### **Trial**

During the two-day trial on December 18-19, 2007, the court received substantial extrinsic evidence, including the exchanged drafts of the merger agreement, limited guarantee and ECL, and the parties’ communications with each other regarding these drafts. Chancellor Chandler, however, found this extrinsic evidence “ultimately not conclusive” and “too muddled” to find that either party’s interpretation of the merger agreement represented “the common understanding of the parties.” *Id.* at \*1, 48.

The Court of Chancery was thus compelled to move beyond so-called “objective” indicators of the parties’ intent (*i.e.*, the contracts themselves and the extrinsic evidence regarding the drafts exchanged and statements made in the negotiations) into more “subjective” evidence regarding the intent of the draftspersons. In doing so, the Chancellor applied a rarely used, but well recognized principle of contract interpretation called the “forthright negotiator” principle. Under Delaware law, where an evaluation of the plain meaning of the agreement and extrinsic

evidence does not lead the court to an “obvious conclusion,” the court may apply the forthright negotiator principle to determine the intent of the parties. *Comrie v. Enterasys Networks, Inc.*, 837 A.2d 1, 13 (Del. Ch. 1997). Applying this principle, the Chancellor determined a single, objectively reasonable reading of the merger agreement in RAM’s favor.

The “forthright negotiator principle” is a legal doctrine that rewards honesty and candor in contract negotiations, while disadvantaging a party that does not candidly disclose its beliefs and understandings. Under this principle, “an objectively reasonable interpretation that is in fact held by one side of a negotiation and which the other side knew or had reason to know that the first party held can be enforced as a contractual duty.” *Id.*

Chancellor Chandler found that the evidence showed that RAM and its attorneys believed, following the last major revision, that the merger agreement and related documents limited the buyer-side exposure in the event RAM did not proceed with the merger to a maximum liability of \$100 million, and that, during the concluding stages of the negotiations, RAM’s attorneys repeatedly communicated this understanding to URI. By contrast, Chancellor Chandler found that even if URI harbored a belief that it had a

viable right to specific performance under § 9.10 of the merger agreement, URI and its attorneys consistently failed to communicate this alleged understanding to RAM’s representatives. *Id.* at \*54, 62-63. This failure was the deciding factor. Faced with RAM’s clear communication of its position, Chancellor Chandler found that URI “knew or should have known what [RAM’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.” *Id.* at \*67.

### **Conclusion**

The *United Rentals* decision, though in many respects fact based, contains important lessons for deal lawyers. First, lawyers should recognize that shorthand drafting conventions, like “subject to” and “notwithstanding anything to the contrary,” may not be given full effect by a court, particularly where the drafting convention nullifies rights that the agreement otherwise seems clearly to confer, and where the alternative of more precise drafting would not have imposed significant difficulties. Although deal lawyers regularly economize on time and costs by relying on succinct terms of art to edit documents with minimal

change, the safer practice would appear to be to strike language intended to be nullified, particularly if the provision speaks to an important deal point like remedies in the event of a failure to close. Second, although deal lawyers may at times accept ambiguity in the hope that a court ultimately will interpret the ambiguous provision favorably, they may be at a significant disadvantage in litigation if they fail clearly to express to the other side their client’s understanding of the ambiguous provision. Indeed, if one party has taken steps to communicate its position, the other party may have an affirmative duty to disclose its contrary understanding, failing which the first party’s communicated understanding will, as in *United Rentals*, constitute the agreement of the parties.

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