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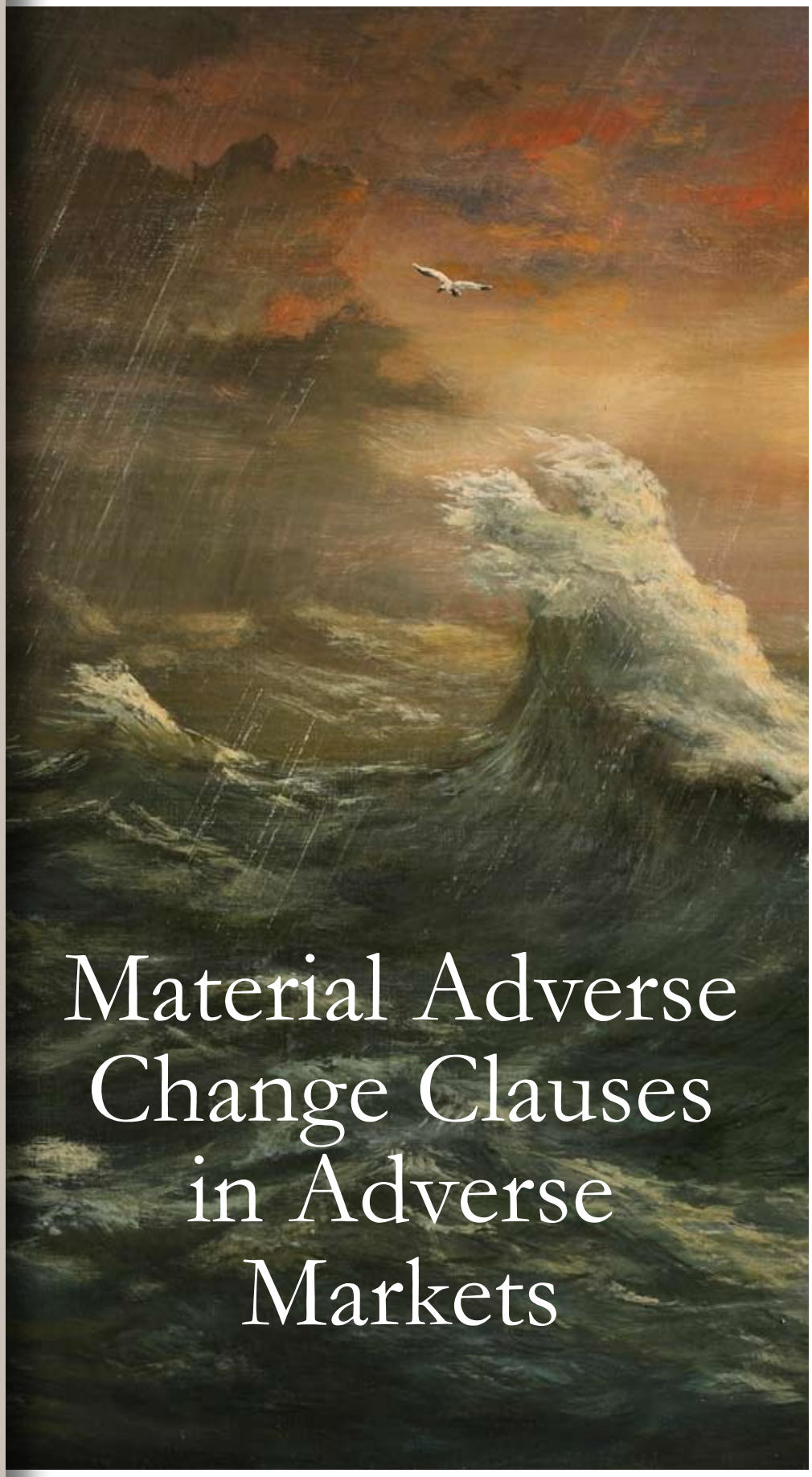

Material Adverse Change Clauses in Adverse Markets

Suhrud Mehta

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    - US$2.8 billion Fujairah Asia Power Company P.J.S.C. on the Fujairah F2 IWPP, the world's second largest Independent Water and Power Project and the biggest power and water project financing ever undertaken in the United Arab Emirates (advising the MLAs, 2007).
    - US$2.1 billion debt financing for the Ambatovy nickel, cobalt and ammonium sulphate project, one of the largest project financings ever undertaken in the mining sector globally (advising the MLAs, 2008).

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Introduction

Tumultuous conditions in credit and syndication markets since August 2007 have given many of us occasion to reflect on material adverse change ("MAC") clauses in financing commitment papers. MAC clauses have been the focus of a number of recent high profile disputes in U.S. courts between borrowers and banks and between buyers and sellers.

A year into the credit crunch, this paper looks at the market MAC clause in the context of U.S. experience, given the dearth of English case law on MAC clauses, with a view to anticipating issues that banks will wish to address when drafting and negotiating this clause. Much of what we say here is applicable to the other form of MAC clause: the business MAC clause.

On the basis of the analysis described in this paper, we suggest changes to the form of a market MAC clause typically used in commitment letters.

Further, because a well drafted clause alone will not be sufficient to avoid a dispute, this paper also highlights practical issues that bankers will wish to bear in mind while negotiating and administering commitment papers.

Finally, we consider the issue of "wrongfully" calling a MAC.

Market MAC Clauses in Adverse Markets: A Closer Look

1. A typical market MAC clause

A typical market MAC condition to a bank's commitment to arrange and underwrite a financing reads as follows[1]:

"The absence, in the Mandated Lead Arranger's opinion, of any event(s), development(s) or circumstance(s) (including any material adverse change or the continuation or worsening of existing circumstance(s) or any combination thereof) which in its opinion, has (have) adversely affected or could adversely affect the international or any relevant domestic syndicated loan, debt, bank, or capital market(s), and which could prejudice syndication of the Facilities, during the period from the date of this letter to the date of signing of the Facility Documents."

2. Anticipating the Issues

As written above, the MAC clause exposes the arranging bank to a number of pitfalls with the potential result that the bank may be committed in circumstances where it did not expect to be.

A number of issues arise while negotiating and drafting a MAC clause: the bank's knowledge of circumstances, statements made by it and its conduct prior to signing the commitment letter, and even post-contractual conduct, all of which may be considered by a court when it construes a MAC clause in a commitment letter.

To our knowledge, the market MAC clause has not been tested in the English courts[2]. Thus, the scope for litigation under an English law commitment letter is greater than if the clause had already been analysed by English courts. A raft of untested arguments are available to a disgruntled borrower and these could form the basis for litigation if the clause is invoked by a bank. Recent complaints, judgments and settlements arising from litigation in the U.S. provide plenty of food for thought (or cause for concern)[3].

(a) Knowledge

U.S. case law supports the proposition that if a bank signs a commitment letter with a MAC condition at a time when the bank is aware of circumstances which could entitle it to invoke the condition, it will be difficult for the bank to invoke the condition on the basis of those circumstances[4].

If adverse circumstances have arisen at the time a commitment letter is being negotiated, the commitment letter should make it clear that the parties intend that the MAC condition may be invoked based on certain pre-existing and known circumstances (or any worsening of such circumstances). Clear drafting which establishes this intention is unlikely to be ignored by an English court.

(b) Construction of the Term "Materially Adverse"

A key issue is whether a material adverse change in

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1 This is substantially the form recommended by the Loan Market Association ("LMA"). It is generally accepted as being favourable to banks (and is more favourable to banks in certain respects than standard forms used by a number of banks). It is very likely to be negotiated back to a more balanced position.

2 In the cases of WPP v Tempus and East Surrey Holdings plc v. Kellen Acquisitions Ltd, the Takeover Panel made determinations of a MAC condition in offer documents in the context of the City Code on Takeovers and Mergers (see Panel Statement 2001/15, 6 November 2001 and Panel Statement 2005/40 of 17 October 2006, respectively). Whilst the Panel's rationale in these cases is occasionally cited as precedent in the context of MACs employed in financing commitment papers, we do not see it as relevant in this context. It is, in our view, very unlikely to be applied in the context of a MAC under financing commitment papers.

3 See, for example, the following: In re IBP, Inc. Shareholders' Litigation v Tyson Foods, Inc. and Lasso Acquisition Corporation, 789 A.2d 14, Del. Ch., 2001, 16; SLM Corporation v JC Flowers II LP, et al, Verified Complaint C.A. No. 3279-VCS (Del. Ch. Oct 8, 2007); United Rentals, Inc. v RAM Holdings, Inc. and RAM Acquisition Corp. Civ. A. No. 3360-CC, 2007 WL 4496338 (Del. Ch. Dec. 21, 2007); In re: Solutia Inc. et al; Solutia Inc. v Citigroup Global Markets Inc. (Case no. 03-17949 (PCB)) (Feb 2008); Wachovia Bank v Newport Television LLC (State of North Carolina, County of Mecklenburg, in the general court of justice superior court division, Civil Action No: 08-CvS 4056 (Complaint filed 22 February 2008); Clear Channel Communications Inc v Citigroup Global Markets Inc (Texas, Cause no. 2008CI04864, Complaint filed 26 March 2008); and BT Triple Crown Merger Co Inc. v Citigroup Global Markets Inc (New York, Complaint filed 26 March 2008).

4 See, for example, Sinclair Broadcast Group v Bank of Montreal, SLM Corporation v JC Flowers II LP, et al, Verified Complaint, Re Solutia Inc. et al; and Solutia Inc. v Citigroup Global Markets Inc, & Oths.

markets has occurred. Whilst this determination is largely one of fact and one which the court will need to make, it is also a question of construing the agreement and its language. In other words, the court must discover the parties' intentions in order to establish the meaning of "materially adverse".

The extent and duration of dislocation in markets since the commencement of the credit crunch means that what a bank may have regarded as "materially adverse" in, say, January 2007 – i.e., in a seemingly robust bull market – was a more significant market event than what it regards as "materially adverse" in today's fragile market. The borrower, however, may argue that "materially adverse" is an absolute standard – e.g., if a 500 point (or 5%) fall in a hypothetical index would be necessary for a change to be "materially adverse" prior to the credit crunch, then in today's market a further 500 point (i.e. more than a 5%) fall would be required notwithstanding extensive deterioration in market conditions.

To minimise the risk of litigation on this point, a market MAC clause written in today's market should clarify that the materiality determination must be made in the context of a market which has already fallen considerably and, accordingly, the bank may invoke the clause even if further deterioration in market conditions is relatively minor. Suggested language to address this potential pitfall is set out in paragraph 3 below.

(c) Determination that a MAC has occurred

Must the bank make the MAC determination in good faith and on a reasonable basis?

English contract law does not generally impose a duty to act in good faith or to act reasonably. **However, where a determination is crucial to whether or not the bank will be obliged to perform its principal obligation under the commitment letter (i.e., to lend), an English court is likely to require that such a determination be made on a bona fide basis[5].**

If the MAC clause provides that the bank can make the MAC determination "in its sole discretion", this improves the position but there remains a risk of challenge. Banks should assume that English courts are unlikely to find that this provision confers the right to invoke the MAC clause arbitrarily or without justification[6].

(d) Modern Construction of Contracts, in General

An important (and often overlooked) area is the English courts' "modern approach" to the construction of contracts. Whilst a discussion of this approach is outside the scope of this paper, a key point is that banks should be wary of relying on an overly technical or literal approach to the construction of terms of commitment letters. To quote Lord Hoffman:

"The interpretation of a legal document involves ascertaining what meaning it would convey to a reasonable person having all the background knowledge which is reasonably available to the person or class of persons to whom the document is addressed."[7]

A couple of leading examples illustrate this point.

In the ICS case[8], the House of Lords held that "any claim (whether sounding in recission for undue influence or otherwise)" in fact meant "any claim sounding in recission (whether for undue influence or otherwise)".

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5 For example, in Citibank International plc v Kessler and another, [1999] All ER (D) 248, the Court of Appeal appeared to accept that the bank's refusal to consent must be "bona fide", i.e. that it must not be withheld for reasons other than the protection of the bank's security. The court was unwilling to imply a term that the bank must act reasonably in exercising a discretion (in this case, in withholding its consent).

6 By using clearer words, it should be possible to move away from such limitations. However, from a practical perspective it will be difficult to include language acceptable to a borrower that makes it explicit that the parties intended that the power may be exercised without justification.

7 Lord Hoffman in Hombourg Houtimport BV v Agrosin Private Ltd and others, 'The Starsin', [2003] All ER (D) 192 (Mar).

8 Investors Compensation Scheme Ltd v West Bromwich Building Society; Investors Compensation Scheme Ltd v Hopkin & Sons (a firm) and others; Alford v West Bromwich Building Society and others; Armitage v West Bromwich Building Society and others [1998] 1 All ER 98.

In BCCI v Ali[9], the House of Lords found that a contract in which employees accepted certain settlement terms, "in full and final settlement of all or any claims of whatever nature that exist or may exist against the bank", could not cover "stigma claims", which were not contemblated at the time the settlement agreement was entered. If the parties had wanted to exclude unknown claims, the House of Lords said they should have said so expressly.

As a result, even if the language of a commitment letter could be read in a vacuum or literally as supporting a result that may be regarded as "harsh" to the borrower or surprising to a "notional reasonable person"[10], there is a real risk that the English courts will arrive at a more balanced or reasonable interpretation and potentially counter to a bank's desired position. This risk is heightened if the factual background surrounding the negotiations supports such a construction.

In short, careful drafting of commitment letters to tackle sensitive issues in a clear manner is key given the absence of English case law on MAC clauses and the English courts' approach to construction of contracts.

A look at the Cerberus - United Rentals case in the US:

The "forthright negotiator principle" is a US legal doctrine adopted by the judge in this case to reward 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."[11] Although clearly not applicable in England, the judge's conclusions in this case are not entirely different to those which an English court could arrive at. Further details of this fascinating case are set out in Appendix 2.

3. Suggested Revisions to the market MAC Clause

In light of these issues, in the context of current market conditions we would suggest certain changes (indicated in the italicised text below) to the LMA's form of the market MAC clause:

"The absence, in the Mandated Lead Arranger's opinion, of any event(s), *development(s)* or circumstance(s) (including any material adverse change or the continuation *or worsening of* existing circumstance(s) *or any combination thereof*) which in its opinion, has (have) adversely affected or could adversely affect the international or any relevant domestic syndicated loan, debt, bank or capital market(s) [and which in the opinion of the Mandated Lead Arranger could prejudice syndication of the Facilities][12], during the period from the date of this letter to the date of signing of the Facility Documents.

It is understood and agreed by each of the parties hereto that circumstance(s) and condition(s) in each of the markets referred to above have deteriorated significantly prior to the date of this letter and that therefore even a small further change or worsening of such circumstance(s) or condition(s) or the occurrence of new event(s), development(s) or circumstance(s) that might not otherwise be regarded as materially and adversely affecting such markets could be materially adverse to such markets in the context of the transactions contemplated by this letter.

[*The Mandated Lead Arranger may not invoke this paragraph solely with respect to event(s), development(s) or circumstance(s)*

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9 Bank of Credit and Commerce International SA (in liquidation) v Ali and others, [2001] 1 All ER 961.

10 The notional reasonable person was referred to by Mummery LJ in Proforce Recruit Ltd v The Rugby Group Ltd, [2006] All ER (D) 247 (Feb). Similar concepts have been employed in a number of recent cases which follow from the judgment of Lord Hoffman in Investors Compensation Scheme Ltd v West Bromwich Building Society [1998] 1 AER 98.

11 United Rentals, Inc. v RAM Holdings, Inc. and RAM Acquisition Corp Civ. A. No. 3360-CC, 2007 WL 4496338 (Del. Ch. Dec. 21, 2007).

12 The US case, In re Solutia, shows that banks should wary of wording that limits the MAC to a change that "could prejudice syndication of the Facilities". In the Solutia complaint, one of the arguments made by the borrower was that the bank had successfully syndicated another comparable transaction in the same market. Accordingly, it was argued the bank could not claim that the changes in market conditions prejudiced syndication of the facilities.

which are generally known to be in existence on the date of this letter in the absence of any change (including worsening) therein.]"

We would expect the square bracketed words to be included if the commercial agreement between the bank and borrower is that the bank is providing a commitment despite current market conditions. Standard forms used by banks seek to write MAC clauses so that the MAC condition may be invoked on the basis of existing market circumstances, but this is unlikely to be acceptable to a borrower (especially if it is required to pay a fee for the commitment, e.g., on investment grade transactions).

In many cases, at the time a commitment letter is signed a bank does not expect to be able to withdraw its commitment on the basis of pre-existing circumstances, i.e., absent any adverse change. Accordingly, the other changes above to the MAC provision are designed to achieve a solution which is likely to be acceptable to a borrower whilst preserving the bank's rights in case of a further deterioration in markets. This form has been adopted on one of the largest ever acquisition finance underwritings.

A good example is this — by including this language in a commitment letter provided in, say, July this year, the wording makes it clearer, and thus easier to establish, that the Chapter 11 filing by Lehman Holdings may be regarded as a materially adverse change in markets. In doing so, the wording reduces the risk of litigation (there is less scope for a potential counter-view to be raised) and, equally important, adverse publicity.

4. Pre-Contractual Statements and Negotiations

Statements made during negotiations, prior to signing commitment papers, could be very harmful in subsequent litigation. Consider the following example:

During negotiations, the borrower questions the market MAC clause as conflicting with the borrower's need for fully committed facilities. In response, the banker says, "It's just boiler plate from the dark ages; the bank has never called it."[13] The banker goes on to say, "We will hold the debt if it doesn't syndicate."

Absent a robust "entire agreement" clause, it will be difficult to ensure that such statements are not held against the bank when it seeks to invoke the market MAC clause[14]. **Thus, the market MAC clause should always be accompanied by a confirmation from the borrower that it is not relying on any pre-contractual statements which may have been made by the bank.**

Modifications we would suggest to the LMA's entire agreement clause[15] are highlighted below in italics:

(i) "The Mandate Documents set out the entire agreement between the Company[,]/[and] the

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13 Similar statements were alleged to have been made by the bank in Sinclair Broadcast Group v Bank of Montreal, 94 Civ 4677 (SDNY 1995), which relates to a business MAC clause in a financing commitment for Sinclair Broadcast Group, and the complaint filed by Solutia Inc against Citi, GS, Deutsche Bank (Solutia Inc. v Citigroup Global Markets Inc. (Case no. 03-17949 (PCB)) (Feb 2008)), which relates to a market MAC clause in a financing commitment for a bankruptcy exit financing. See Appendix 1 for further details.

14 See Thomas Witter Ltd v TBP Industries Ltd, [1996] 2 All ER 573, which considered whether the following clause excluded any liability for misrepresentation (including a pre-contractual one):

"This Agreement sets forth the entire agreement and understanding between the parties or any of them in connection with the business and the sale and purchase described herein. In particular, but without prejudice to the generality of the foregoing, the Purchaser acknowledges that it has not been induced to enter into this Agreement by any representation or warranty other than the statements contained or referred to in Schedule 6." Jacob J (in the Court of Appeal) said, "in my judgment the first sentence does not operate to exclude remedies for pre–contractual misrepresentations. It simply does not say it does. If it said, for instance, 'The vendor agrees that he will have no remedy in respect of any untrue statement made to him upon which he relied in entering this contract and that his only remedies can be for breach of contract' the clause would probably have done the job. Then, if he is sold a pup, he will have no remedy unless it is a contractually warranted pup (I here gratefully adapt the language of Shaw LJ in Esso Petroleum Co Ltd v Mardon [1976] 2 All ER 5 at 26, [1976] QB 801 at 832)).

Unless it is manifestly made clear that a purchaser has agreed only to have a remedy for breach of warranty I am not disposed to think that a contractual term said to have this effect by a roundabout route does indeed do so. **In other words, if a clause is to have the effect of excluding or reducing remedies for damaging untrue statements then the party seeking that protection cannot be mealy-mouthed in his clause. He must bring it home that he is limiting his liability for falsehoods he may have told."**

Mandated Lead Arrangers and the Underwriters as to arranging and underwriting the Facility/ies and supersede any prior oral and/or written understandings or arrangements relating to the Facility/ies.

(ii) *Subject to paragraph (iii), the Company acknowledges that it has not relied on, or been induced to enter into the Mandate Documents by, any representation, warranty, collateral contract or other assurance other than those (if any) expressly set out in the Mandate Documents [and any other documents incorporated into the Mandate Documents] made by or on behalf of any other party before the date of the Mandate Documents. The Company waives all rights and remedies that, but for this clause [•], might otherwise be available to it with respect to any such representation, warranty, collateral contract or other assurance.*

(iii) *Nothing in paragraph (ii) shall limit or exclude any liability for a fraudulent misrepresentation.*

(iv) Any provision of a Mandate Document may only be amended or waived in writing signed by the Company and each of the Mandated Lead Arrangers and Underwriters."

Note, however, that courts will draw a distinction between excluding liability for pre-contractual statements and referring to pre-contractual negotiations to shed light on the meaning intended by the parties. **Accordingly, if an English court considers the factual background in order to interpret a contract, pre-contractual statements will be relevant for this purpose and may be considered by the court (i.e. the "entire agreement" clause will not preclude such consideration).**

5. Post-Contractual Conduct

As a general rule, the interpretation of an English law contract will not turn on the parties' conduct after the formation of the contract. However, post-contractual conduct could be very relevant to the outcome of a dispute on a MAC clause.

Consider the following events, which can occur in the context of a typical acquisition financing:

Following the signing of a commitment letter incorporating a MAC condition the bank and the borrower discuss aspects of the proposed M&A transaction which have an impact on the financing. They agree to make amendments to the terms and conditions of the financing commitments. In addition, the bank may receive fees in consideration for its agreement to such amendments.

Prior to any such amendment taking effect, the bank may say or do things which lead the borrower to believe that the commitment is and remains fully effective (in particular that the MAC condition has not been triggered).

The borrower and, indeed, the "notional reasonable person", may infer (absent clarification to the contrary) that the fact that an amendment to the terms of the financing commitments is being made (often described as an "amendment and restatement") must mean that the MAC clause has been "refreshed" or that the "slate has been wiped clean" and, accordingly, the MAC clause no longer relates to circumstances relevant prior to the amendment.

An English court may find that the bank's conduct was unconscionable or gives rise to an estoppel precluding it from invoking the MAC clause on the basis of circumstances preceding the date of the amendment, the agreement to pay a fee or other conduct by the borrower to its detriment.

There is also the risk that the court approaches statements made prior to an amendment taking effect in the same light as pre-contractual statements (considered in paragraph 5 above).

This raises the following question: If a bank is aware of a MAC having occurred between signing and the date of the amendment, will it relinquish its right to invoke the MAC clause in the future if it does not promptly notify the borrower of its entitlement to call the MAC (and preserving its right to invoke the MAC

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15 See paragraph 19 of the LMA's Mandate Letter (Underwritten).

in the future)? We cannot be certain. **A prudent bank will ensure that it is as careful in relation to post-contractual conduct as it would be in relation to pre-contractual conduct and that any amendment is documented so as to preserve the entitlement to call a MAC on the grounds of circumstances existing prior to the amendment taking effect (unless, of course, other considerations prevail).**

6. Liability for "wrongfully" calling a MAC

In Concord Trust v Law Debenture Trust Corporation plc[16], the House of Lords held that, absent bad faith or malice, there can be no liability for so called "wrongful acceleration" (i.e., where the bank believes that it is entitled to accelerate the debt but it is subsequently proven that no such entitlement existed). The reasoning was that, absent an express term prohibiting the issue of an invalid notice of acceleration, such a term would not be implied into the agreement unless it was necessary to give business efficacy to the contract[17]. The notice of acceleration was simply ineffective.

This raises the question whether a potential liability could arise in tort, as opposed to contract law, for negligently giving a notice of acceleration or of cancellation of the facility. The House of Lords rejected this in Law Debenture on the grounds that there was no contractual duty in the first place and so the question of a tortious liability could not arise. However, there is the risk of liability in tort or otherwise under the laws of another jurisdiction, e.g. the jurisdiction of incorporation or in which the borrower conducts its business.

The House of Lords' logic in a wrongful acceleration case does not extend to the wrongful exercise of a MAC clause in commitment letters. A bank that invokes a MAC clause in circumstances where a court later finds the bank was not entitled to do so would be in breach of its commitment to provide the facility. The bank would be at risk of liability for damages for breach of contract.

It is unlikely that a borrower will be able to obtain specific performance if the bank fails to lend (*South African Territories v Wallington*[18]). However, in *Loan Investment Corp of Australasia v Bonner*[19] the Privy Council said, without elaboration, that specific performance of an unsecured loan agreement might be awarded 'in exceptional circumstances'.

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16 [2005] UKHL 27/[2005] 1WLR 1591.

17 See paragraph 37 of the HL judgment in the Law Debenture case, which cited The Moorcock, [1889] 14 PD 64 at 68. This reasoning was followed by Evans-Lombe J in BNP Paribas v Yukos Oil [2005] EWHC 1321 (see paragraphs 23 and 24 of the judgment in that case). In our view there are sound reasons to expect that this reasoning will **not** be applicable to the acceleration of a fully drawn revolver, i.e. where lenders refuse to permit "roll-over" of drawn loans.

18 [1898] AC 309.

19 [1970] NZLR, 724 PC.

Appendix 1

SOLUTIA

Re Solutia Inc. et al; Solutia Inc. v Citigroup Global Markets Inc, & Oths[20]:

In 2003, Solutia, a Delaware company and its affiliated debtors ("Solutia") filed a voluntary petition for bankruptcy under chapter 11 of the U.S. Bankruptcy Code. On October 15, 2007, Solutia filed its Fifth Amended Joint Plan of Reorganisation (the "Plan") seeking to facilitate their emergence from chapter 11. Under the Plan, Solutia required an exit credit facility to fund distributions, replace Solutia's debtor-in-possession credit facility, and provide working capital.

On October 25, 2007, the Commitment Parties signed a Commitment Letter to fund a $2 billion long-term exit financing package for Solutia. The Commitment Letter provided that the commitments were subject to "the absence of any adverse change since the date of the Commitment Letter in the loan syndication, financial or capital markets generally that, in the reasonable judgement of such Commitment Party, materially impairs syndication" of the financing (the "market MAC Provision").

On November 20, 2007, the court approved the exit financing package, and nine days later (in reliance on the Commitment Letter), the court found the Plan to be feasible and approved it.

On January 20, 2008, on a call to discuss closing, the Commitment Parties cited the market MAC Provision, stating that they would refuse to close and fund on January 25, 2008 if requested to do so. This was reiterated at a meeting on January 22, and in a letter of January 30 where the Commitment Parties refused to fulfil their obligations under the Commitment Letter at that time.

Solutia filed a suit for specific performance on February 6, 2008 in the Bankruptcy Court to order the Commitment Parties to provide the financing they had committed.

In its complaint, Solutia claimed that Citi created the impression that the market MAC Provision was nothing more than recycled boiler plate. Solutia alleged that Citi had explained that the market MAC Provision was included in the Commitment Letter simply to comply with old-line bank policy, that Citi had never called a market MAC provision, and that it had minimized its significance. Solutia also argued that the Commitment Parties were aware of the adverse market conditions prior to execution of the Commitment Letter.

Solutia argued therefore that the Commitment Parties could not rely on the market MAC Provision in the midst of a tumultuous market that was not only foreseeable, but had long existed when they signed the firm commitment.

On February 25, 2008, Solutia reached an agreement with the Commitment Parties to fund Solutia's exit financing package. The Commitment Parties agreed to waive the market MAC Provision. Solutia agreed to dismiss the lawsuit once the exit financing was funded. Solutia emerged from bankruptcy on February 28, 2008.

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20 (Case no. 03-17949 (PCB)) (Feb 2008).

Appendix 2

THE FORTHRIGHT NEGOTIATOR - UNITED RENTALS

This appendix is a copy of the Milbank Litigation Client Alert dated January 8, 2008 by Robert Hora entitled "Delaware Court of Chancery Holds That Target May Not Force Private Equity Firm to Proceed with Buyout", further information in relation to which can be obtained from Scott Edelman, Michael Hirschfeld and Daniel Perry.

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 break-up fee[21]. 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 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

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

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, "[an] 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 to 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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