Reverse break-up fees: the ultimate option?

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Many recent LBO merger agreements do not require the buyer to specifically perform its obligations, so a buyer's right to walk and pay a reverse break-up fee is generally clear, writes Jack Boden of law firm Covington & Burling.

In the much anticipated decision about reverse break-up fees in LBOs, on December 21, 2007, the Delaware Chancery Court found that affiliates of Cerberus (the "Cerberus Entities") were not subject to a specific performance clause contained in their merger agreement with United Rentals, Inc. ("URI"), and instead were permitted to walk away from their $7 billion agreement to acquire URI by payment of a $100 million reverse break-up fee. The Court found that the agreement was ambiguous and that URI knew or had reason to know that Cerberus understood the agreement to preclude the remedy of specific performance. Because of the specific facts relating to ambiguous drafting and the intent of the parties, the decision may be of limited precedential value. It should, however, focus buyers and sellers in future LBOs to seek clarity in the interplay between reverse break-up fees and specific performance clauses, as well as other significant deal terms.

Observations

While this conflict in terms is not unique, many recent LBO merger agreements do not require the buyer to specifically perform its obligations, so a buyer's right to walk and pay the reverse break-up fee is generally clear. The issue in other recent LBOs in the news (e.g., Harman and Sallie Mae), where the agreements did not include a specific performance clause in favor of the seller, is whether a material adverse change has occurred and the buyer can terminate without paying any break-up fee.

Background

After soliciting offers from third parties to acquire URI, on July 22, 2007, the Cerberus Entities and URI entered into a merger agreement pursuant to which Cerberus agreed to acquire URI for $34.50 per share in cash.

The Cerberus Entities are shell entities with *de minimis* assets that were formed by Cerberus Partners L.P. solely to effect the acquisition of URI. Cerberus Partners guaranteed the payment of $100 million to cover the reverse break-up fee. Another Cerberus affiliate, Cerberus Capital Management, executed an equity commitment letter under which it agreed, on behalf of affiliated funds or managed accounts, to purchase shares of one of the Cerberus Entities for an aggregate purchase price of $1.5 billion, subject to the satisfaction of all of the conditions to the obligations of the Cerberus Entities to effect the closing of the merger under the URI merger agreement, including the receipt of the debt financing. Neither Cerberus Partners nor Cerberus Capital Management were a party to the merger agreement, and the equity commitment letter made clear that URI was not a third party beneficiary. The URI merger agreement contained two key provisions that were heavily negotiated between the parties and were central to the instant case. Section 9.10 of the URI merger agreement, entitled "Specific Performance," provides in part:

The parties agree that irreparable damage would occur in the event that any provisions of this Agreement were not performed in accordance with their specific terms or were not otherwise breached. Accordingly...[URI] shall be entitled to seek an injunction or injunctions to prevent breaches of this Agreement by [the Cerberus Entities] or to enforce specifically the terms and provisions of this Agreement and the [g]uarantee to prevent breaches of or enforce compliance with those covenants of [the Cerberus Entities] that require [the Cerberus Entities] to (i) use [their] reasonable best efforts to obtain the [f]inancing and satisfy the conditions to closing...and (ii) to consummate the transactions contemplated by this Agreement, if in the case of this clause (ii), the [f]inancing...is available to be drawn down by [the Cerberus Entities] pursuant to the terms of the applicable agreements but is not so drawn down solely as a result of [the Cerberus Entities] 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...under the circumstances provided therein.

Section 8.2(e) of the URI merger agreement, entitled "Termination, Amendment and Waiver," provides in part that URI's sole and exclusive remedy in the event of termination of the URI merger agreement as a result of a breach by the Cerberus Entities is the payment of the $100 million reverse break-up fee. Section 8.2(e) of the URI merger agreement further provides that:

In no event, whether or not this agreement has been terminated pursuant to any provision hereof, shall [the Cerberus Entities or any Cerberus affiliate], either individually or in the aggregate, be subject to any liability in excess of the [$100 million reverse break-up 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 [the Cerberus Entities] of any representations, warranties, covenants or agreements contained in this Agreement, and *in no event shall the [URI] seek equitable relief or seek to recover any money damages in excess of such amount from [the Cerberus Entities or any Cerberus affiliate] or any of their respective [r]epresentatives.*

On November 14, 2007, Cerberus notified URI that it would not proceed with the transaction on the terms set forth in the URI merger agreement and indicated its willingness to enter into discussions to acquire URI on revised terms or alternatively pay the $100 million reverse break-up fee. Cerberus' actions were a surprise to the market, then trading within a percent or two of the deal price, because it was widely reported that Cerberus' debt financing sources continued to be ready to finance the URI acquisition. Cerberus did not allege that URI suffered a "material adverse change" or otherwise breached the URI merger agreement. URI rejected Cerberus' offer to renegotiate and on November 19, 2007, filed a lawsuit in Delaware Chancery Court seeking specific performance of the URI merger agreement.

URI contended that it was entitled to specific performance of the merger agreement under Section 9.10 and the Court should force Cerberus to consummate the acquisition. URI argued that the language of Section 8.2(e) was meant as a limitation on damages in the event of a *termination* of the URI merger agreement, which was not the case, and that the $100 million cap on damages was limited to circumstances where equitable remedies involved monetary damages, such as restitution or rescission.

While acknowledging that the URI merger agreement would have been more clear had Section 9.10 been revised or deleted in its entirety, Cerberus argued that it is unreasonable to limit the phrase "equitable relief" to those equitable remedies that include monetary damages, and otherwise contended that during the negotiations Cerberus consistently took the position that the $100 million reverse break-up fee was its maximum exposure for choosing not to consummate the acquisition and sought to preclude URI's ability to seek equitable relief.

In denying URI's motion for summary judgment, the Court found that Sections 9.10 and 8.2(e) of the URI merger agreement are susceptible to more than one reasonable interpretation and the resulting ambiguity in the contract made summary judgment inappropriate.

Following a two day trial, the Court concluded that URI failed to meet its burden of proving that the common understanding of the parties was that the URI merger agreement allowed for the remedy of specific performance, and that URI was entitled to such a remedy and found in favor of Cerberus.

On December 24, 2007, URI publicly stated that it was not appealing the Delaware Chancery Court's decision and Cerberus agreed to pay URI the $100 million reverse break-up fee.

The Court's Analysis

The Court dubbed the agreement a "hopelessly conflicted contract" and from the extrinsic evidence was unable to conclude that there was a single, shared understanding with respect to the availability of specific performance. Applying the "forthright negotiator" principle, under which "the subjective understanding of one party to a contract may bind the other party when the other party knows or has reason to know of that understanding," the Court found evidence that Cerberus and its advisors reasonably understood the URI merger agreement to preclude the remedy of specific performance and that URI and its advisors knew or had reason to know of this understanding. The Court also concluded that, while URI might have reasonably believed it was entitled to specific performance under the terms of the later-stage URI merger agreement drafts, this belief was not effectively communicated to Cerberus such that Cerberus would know or have reason to know of URI's understanding.

In reaching these conclusions, the Court noted that

- throughout the negotiation process, Cerberus took every effort to limit its exposure should it fail to close to transaction (e.g. the equity commitment letter from Cerberus Capital Management disclaimed third party beneficiary rights, the limited guarantee contained "no recourse" language and the language in Section 8.2(e) of the URI merger agreement which sought to limit Cerberus' liability and preclude specific performance as a remedy);

- even though Cerberus' advisor failed to strike the ambiguous language in Section 9.10, it nevertheless communicated to URI its understanding that the agreement precluded specific performance; and
- URI's advisors failed to or chose not mention that it believed specific performance was an available remedy when Cerberus and its representatives indicated during later-stage negotiations that Cerberus believed it was buying an option to acquire URI or otherwise had a maximum exposure equal to the reverse break-up fee.

Implications

Reverse Break-Up Fees Are What They Are. Reverse break-up fees have become a common feature of LBO merger agreements, and are typically designed to permit the LBO firm to limit its exposure to the amount of the fee. The United Rentals case only underscores that purpose even where the contract included a provision, albeit ambiguous, requiring the buyer to specifically perform its obligations. In many other LBO merger agreements, specific performance is limited to the seller's obligations.

Strategics Return. With the recent subprime meltdown, we may see LBO firms wanting even greater flexibility as a result of the volatility of the debt markets, including a return to financing outs. In any event, sellers can be sure that reputational risk will no longer insure certainty of closing where a reverse break-up fee is present. This could be a factor in strategic buyers regaining ground in the m&a charts because the absence of reverse break-up fees and the presence of specific performance in favor of sellers in strategic deals add to closing certainty. But we also see the astute LBO firms benefiting from the reduced level of m&a activity and leveraged financing, and the attendant lower prices.

Drafter Beware. A more overarching implication is that the Delaware Chancery Court reminded buyers and sellers to beware of ambiguous drafting. While the record is not clear, the Court indicated that it believed neither side relished the idea of taking head on the disagreement of whether the buyer had a specific performance obligation. The buyer could have insisted to eliminate the specific performance language altogether as it had in several earlier drafts, and the seller could have refused to include the language that strongly suggested that such right was limited. The Court's message in United Rentals is clear: if you are unwilling to take on the deal term directly, you risk letting a Court decide who is the better communicator.

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