January 3, 2008

MEMORANDUM TO: Clients and Friends of the Firm

RE: Delaware Chancery Court Limits Liability to Break Up Fee in Merger Termination – *United Rentals, Inc. v. RAM Holdings, Inc., et al.* Case[1]

In a decision that highlights an effective, albeit not bullet-proof, strategy to limit broken deal liability to the amount of a termination or break up fee in a merger agreement, on December 21, 2007, the Court of Chancery of the State of Delaware rendered a verdict in *United Rentals, Inc. v. RAM Holdings, Inc. and RAM Acquisition Corp.*, Case. No. 3360-CC (Del. Ch. Ct. Dec. 21, 2007). Following a two-day bench trial, Chancellor William Chandler refused to grant specific performance, which would have forced RAM Holdings, Inc. and RAM Acquisition Corp., two holding companies affiliated with Cerberus Capital Management, L.P. and Cerberus Partners, L.P. (collectively, "Cerberus"), to consummate a merger with United Rentals, Inc. ("United Rentals"). Although commentators and market participants anticipated that the $7 billion dispute would focus on whether a Material Adverse Change ("MAC") had occurred, instead the ruling was based on what the court called "buyer's remorse," and relied exclusively on remedy provisions in the Merger Agreement in concluding that Cerberus' liability for walking away from the deal was capped at the $100 million "Termination Fee."[2]

Formation and Termination of the Merger Agreement

On July 22, 2007, United Rentals entered into a Merger Agreement with Cerberus. Within months, however, Cerberus notified United Rentals that it would not proceed with the transaction but instead would either (a) negotiate new terms, or (b) make arrangements for the payment of the $100 million Termination Fee. Rather than negotiate, United Rentals filed a lawsuit seeking specific performance under the Merger Agreement.

The Relevant Terms of the Merger Agreement

United Rentals argued that Cerberus was required to consummate the transaction based on Section 9.10 of the Merger Agreement which provided 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. … [United Rentals] shall be entitled to seek an injunction or injunctions to prevent breach of this Agreement by [Cerberus] or to enforce

[1] In some jurisdictions, this memorandum may constitute attorney advertising. This memorandum was prepared as a service to clients and other friends of RK&O to report on recent developments that may be of interest to them. The information in it is therefore general, and should not be considered or relied upon as legal advice.

[2] The court concluded that "[a]lthough some in the media have discussed this case in the context of Material Adverse Change ("MAC") clauses, the dispute between URI [United Rentals] and Cerberus is a good, old-fashioned contract case prompted by buyer's remorse." *United Rentals*, slip op. at 65-66.

specifically the terms and provisions of this Agreement." This provision, however, was "subject in all respects to Section 8.2(e)" of the Merger Agreement, which permitted Cerberus to terminate the Merger Agreement upon payment of a $100 million Termination Fee. Section 8.2(e) also provided that the Termination Fee was "the sole and exclusive remedy . . . for any and all loss or damage suffered as a result thereof and upon any termination specified in . . . this Section 8.2(e) and . . . [Cerberus shall not] have any further liability or obligation of any kind or nature relating to or arising out of this Agreement or the transactions contemplated by this Agreement as a result of such termination. . . [I]n no event shall [United Rentals] seek equitable relief or seek to recover any money damages in excess of [the Termination Fee]" from Cerberus.

United Rentals argued that, despite the language of Section 8.2(e), it was entitled to specific performance as a result of Cerberus' termination of the Merger Agreement under Section 9.10. United Rentals contended that the Termination Fee provision operated as the "sole and exclusive" remedy only if one of the parties "terminated" – as opposed to breached – the Merger Agreement. Termination was a defined term in the agreement and was not the equivalent of a breach. Cerberus did not dispute the fact that neither party terminated the agreement pursuant to Section 8, instead it argued that Section 8.2(e) limited *all remedies* in the event the agreement terminated, whether by breach or "termination."

Evidence of the Parties' Negotiation Revealed that Cerberus Clearly Believed its Liability Was Limited to $100 Million

The court found the Merger Agreement language with respect to the Termination Fee as the sole remedy to be ambiguous. Therefore, the court applied what is known as the "forthright negotiator principle" to determine whether (1) Cerberus subjectively believed that United Rentals would not have specific performance as a remedy, *and* that United Rentals knew or should have known that Cerberus held that belief, or (2) United Rentals subjectively believed that it maintained a specific performance remedy, *and* that Cerberus knew or should have known that United Rentals held that belief. *Id.* at pp. 47-48. The court concluded that if, in fact, United Rentals believed that it maintained the remedy of specific performance, its counsel "categorically failed to communicate that understanding to [Cerberus]" while Cerberus' counsel "did communicate to [United Rentals] its understanding that the Agreement precluded any specific performance rights" and that communication was not contradicted by counsel for United Rentals.

Effectively, Cerberus believed it had negotiated a $100 million option to purchase the stock of United Rentals. Indeed, evidence presented at trial reflected that Cerberus' counsel told counsel for United Rentals that "it was important for [Cerberus] that the language . . . reflect the agreement that the only remedy available to United Rentals, if Cerberus didn't proceed with the closing, was the break up fee. . .," to which United Rentals' counsel responded, "I get it." Moreover, United Rentals' counsel "did nothing to dissuade [Cerberus] that [its] understanding of the transaction was erroneous." *Id.* Thus, while the court found that the language of the Merger Agreement equally supported the positions of Cerberus (that it purchased an option, limiting its potential damages in the event that it terminated the Merger Agreement to $100

million) and United Rentals (that the $100 million Termination Fee applied only in the event of a termination and not breach, in which case United Rentals retained the remedy of specific performance), evidence of the parties' negotiations revealed that counsel for United Rentals knew of Cerberus' interpretation of the agreement and did nothing to dissuade it from that interpretation – effectively allowing Cerberus to sign the agreement while knowing that United Rentals had a materially different view of their rights under the agreement.

Lessons Learned

Following the *United Rentals* decision, a party negotiating a merger agreement that desires a "break up" or termination fee to be enforced as a cap to liability should consider the following: (a) removing any ambiguity regarding the availability of a specific performance remedy from the merger agreement or strictly limiting such a remedy to specific instances or circumstances; (b) affirmatively informing their counterparties of their view that liability is limited to the amount of the "break up" or termination fee, whether the underlying agreement is terminated by breach or "termination;" (c) confirming that their counterparty has the same interpretation of the agreement; and (d) referring to their rights under the merger agreement as an "option," the price of which is the break up fee.

Finally, although Cerberus did not invoke the MAC provision in terminating the United Rentals agreement, presumably, had it done so successfully, Cerberus would not have had to pay a termination fee. Thus, the *United Rentals* case provides a potential, alternative strategy in drafting merger and investment agreements – rather than relying on MAC clauses as an out for failed deals or investments, the investing party might negotiate a sufficiently high termination fee to compensate the target company in the event the investment/acquisition is not consummated. In the *United Rentals* case, the parties apparently negotiated the termination fee intending it to be a "sufficient size to ensure that it would be 'scary' and 'painful' for [Cerberus] to walk away from the transaction." While a break up or termination fee would mean that the terminating party would have some liability (limited to the amount of the fee), as opposed to invoking a MAC clause (in which no fee would be paid), the ultimate amount of potential liability would be capped and the terminating party might have greater certainty that its termination fee would be enforced. In contrast, the enforceability of MAC clauses may, at a minimum, lead to lengthy and costly litigation. Thus, a well-crafted break up fee provision may provide greater certainty and, perhaps, limited costs when compared to the invocation of MAC clauses.

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