NEGOTIATING THE BUYER'S RIGHT TO TERMINATE AN ACQUISITION AGREEMENT POST-CERBERUS

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Many merger and acquisition deals include break-up fees. This requires the seller to pay the buyer a break-up or termination fee if the transaction is not consummated for reasons specified in the purchase agreement, including the seller's acceptance of a competing bid. It is intended to both reimburse a "stalking horse" bidder for the expenses of negotiating and investigating a deal and deter would-be suitors from making competing bids.

A reverse termination fee would seem to be the corollary to the break-up fee. This fee protects the seller by requiring the terminating buyer to reimburse it for its expenses, and typically includes a premium to compensate the seller for the time the company was "off the market." However, a reverse termination fee also benefits the buyer – perhaps more so - by capping its exposure in the event market conditions make it economically unwise to proceed with the transaction.

Until the recent turmoil in the credit markets and consequent retrenching of private equity, reverse termination fees in private equity acquisition transactions were rare. People thought that reputational incentives for buyers would provide certainty of closing. Now that the reputational impact for private equity walking away from a deal in many instances is overcome by the economics, reverse termination fees in merger and acquisition transactions are commonplace and strenuously negotiated.

Negotiating a Reverse Termination Fee

In negotiating a reverse termination

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provision, the buyer typically insists on the right to terminate the transaction *for any reason* upon payment of the negotiated termination fee. This limits the buyer's exposure, and the seller's remedies, in the event the buyer does not close the transaction for any reason including a failure to obtain financing. Under this approach, the buyer effectively retains a post-signing option not to go forward with the transaction at the cost of the reverse termination fee.

The seller will attempt to broaden its remedies in the event the buyer walks away. Specifically, the seller will seek to maintain its right to seek specific performance of the transaction, that is, the right to require the buyer to close. Typically, the seller will draft this provision to limit the buyer's walk-away right to instances where the company has suffered a "material adverse change" in its business condition (known as a "MAC" clause). Absent a MAC, the seller's proposal would hold the buyer to specific performance.

There are additional variants that have been used in deals. The seller could seek to require the buyer to use its best, or commercially reasonable, efforts to obtain necessary financing to close prior to invoking the reverse termination fee clause. Alternatively, the reverse termination fee could be established as the seller's exclusive remedy, but the size of the fee could be fixed at a certain amount for the buyer's failure to close the transaction due to lack of financing, and set at another amount if the buyer fails to close for any other reason.

A recent case involving the acquisition of the retail equipment operator United Rentals, Inc. by Cerberus Capital Management, L.P. put the spotlight on reverse termination fees in private equity deals. The Delaware Chancery Court's opinion highlights the importance of clear and unambiguous contract drafting.

Cerberus/United Rentals

In late-2007, Cerberus informed United Rentals that it was not prepared to proceed with the purchase of the company on the terms set forth in the parties' merger agreement. In the agreement, Cerberus agreed to acquire United Rentals for $34.50 per share in cash, in a transaction valued at the time at approximately $7.0 billion.

Cerberus claimed the reverse termination provision in the purchase contract gave it the option to abandon the transaction for any reason in exchange for a $100 million reverse termination fee. United Rentals argued that Cerberus could not cancel the deal unilaterally, but had to invoke and satisfy the MAC clause or complete the deal. Cerberus conceded there had been no "material adverse change" in United Rentals' business condition, but insisted on its right to

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cancel the transaction in its discretion.

The signed agreement provided United Rentals with equitable remedies including specific performance in the event of Cerberus' breach, but in other provisions specified that the reverse termination fee was its sole and exclusive remedy. The Court's opinion sharply criticizes the drafting efforts of counsel for both sides because they "failed to clearly and consistently communicate their client's positions" with respect to termination rights. Ultimately, the Court found that "the language of the Merger Agreement presents a direct conflict between two provisions on remedies, rendering the Agreement ambiguous." As a result, the Court looked beyond the contract to resolve the dispute.

First, the Court looked to "evidence of the negotiations between the parties." Over 17 pages of the opinion, the Court analyzed the various "redlines" and earlier marked-up versions of the agreement. These drafts sometimes included, and other times removed, United Rentals' right to specific performance in the event Cerberus walked away from the deal. What was clear, however, was that Cerberus made repeated statements in negotiations (by e-mail and otherwise) that it would not proceed with the negotiations or with the deal unless the reverse termination fee was United Rentals' only remedy.

The Court found that United Rentals' sole and exclusive remedy was the $100 million reverse termination fee. The Court expressly stated that Cerberus' attorney was more consistent in his statements that the termination fee was intended to preclude specific performance. Based on this evidence, the Court hung its proverbial hat on a doctrine of contract interpretation known as the "forthright negotiator principle." Under this doctrine, "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." Because United Rentals "knew or should have known" that Cerberus would not have signed the agreement unless the $100 million reverse termination fee was United Rentals' sole and exclusive remedy, the Court allowed Cerberus to walk away from the deal upon payment of the fee.

Incredibly, with billions at stake, the *Cerberus* case came down to poor contract drafting.

Conclusion

Before accepting a reverse termination fee, sellers should carefully consider whether, and to what extent, it is in the best interest of its shareholders to forego certainty of closing. In the wake of the *Cerberus* opinion, the reverse termination provision must be carefully crafted and considered against a number of different clauses in the acquisition agreement. In this context, otherwise "boilerplate" provisions at the end of the agreement can create ambiguity as to available remedies. If this occurs, e-mail and other communications of the parties' intent and understandings become crucial.

Practically, in most acquisition deals confusion on the face of the agreement likely will have the effect of quashing the deal. The buyer, of course, holds the key to closing the deal. An ambiguous agreement will give it leverage to force a selling company to prove its rights through costly, time consuming litigation. The prospects of that cost, plus any urgency to close a sale, will force many sellers to take the reverse termination fee and move on to another buyer.

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