The Deal

VOICE OF THE DEAL ECONOMY

VOL. 7 NO. 23 NOVEMBER 30 — DECEMBER 13 2009

In search of certainty

New, limited optionality in M&A deals

BY JEFFREY MARELL, FRANCES MI AND DEVON WILLIAMS

AFTER A SPATE of busted leveraged buyouts and related litigation, the terms of some recent private equity M&A transactions are evolving in an effort to address issues of deal certainty and buyer optionality.

Specifically, we note a small but growing trend toward limiting buyer optionality in agreements by more clearly defining remedies available to targets upon breach or termination of the agreement.

Cerberus *read the agreement*

Before the financial crisis, most private equity M&A agreements included a reverse breakup fee payable by the buyer.

The breakup fee, along with other provisions, enabled buyers to walk away from pending transactions in certain circumstances or sometimes under any circumstance with capped exposure.

Then the financial crisis hit, and dealmaking rules changed. Frequent announcements of renegotiated, terminated or litigated deals ensued. One transaction in particular focused practitioners on this reverse termination fee structure—Cerberus Capital Management LP's proposed acquisition of United Rentals Inc.

In that transaction, the merger agreement contained conflicting remedies provisions, with the specific performance provision seemingly entitling United Rentals to seek injunctions to prevent breaches of the merger agreement, while the termination provisions stated that in no event may United Rentals seek equitable relief or other damages in excess of Cerberus' agreed-to reverse termination fee.

Upon Cerberus' attempt to pay such fee and end the transaction, United Rentals sued. After lengthy litigation, the Delaware Court of Chancery ultimately held for Cerberus because, among other things, under the forthright negotiator doctrine, United Rentals knew or should have known that Cerberus understood the agreement to bar specific performance and should therefore be held to the benefit of its bargain.

Other cases further highlighted the remedies provisions. In Huntsman Corp.-Hexion Specialty Chemicals Inc., in addition to alleging a typical breach of contract claim, Huntsman also tried to assert extracontractual tort claims against its buyer's parent, Apollo Management LP, and individuals not party to the transaction agreement.

Some recent deals—including private transactions that we have encountered—showcase a new construct that seems to balance a target's desire for deal certainty against a buyer's desire for flexibility and reduced risk of unknown claims.

Generally, under this new construct, specific performance is the target's sole and exclusive remedy under the agreement unless a court declines to specifically enforce the buyer's obligations, in which case it may seek money damages (either up to a specified cap or in a fixed amount that is designated as liquidated damages).

If money damages are granted, the buyer typically has some additional period of time (often two weeks) to complete the transaction before the target can enforce the award of money damages.

The target often can specifically enforce the related equity commitment or limited guarantee given by the private equity sponsor, either as a third-party beneficiary or as a party to those agreements. And there typically is no "financing out" condition.

Will this structure have any staying power?

While the sharp dropoff in private equity M&A since 2007 makes trend spotting difficult, targets may push for this new model as they obtain greater assurance of closing by significantly decreasing the optionality some buyers enjoyed under prior constructs.

Buyers may also favor the certainty of this structure, since it caps their liability at the reverse breakup fee or other liquidated damages amount and does not put them at risk for an unforeseen amount of damages determined by a court or jury after costly litigation. Also, this construct seemingly would reduce the likelihood that the target will be able to successfully assert novel or extracontractual claims against a buyer, since the target's specific performance option has been strengthened, and the drafters of these agreements have gone to great lengths to try to eliminate the possibility of Huntsman-style extracontractual claims.

Finally, both parties would benefit from the clarity of these new structures in that they may avoid contract interpretation issues and lengthy litigation, such as were faced in United Rentals.

While it remains to be seen whether this new construct takes hold, it certainly offers an alternative to how private equity deals have been done in the past and may bridge the gap between target and buyer positions on deal certainty. ■

Jeffrey Marell is a partner, Frances Mi is counsel and Devon Williams is an associate in the M&A group of Paul, Weiss, Rifkind, Wharton & Garrison LLP in New York.