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BY KENNETH A. ADAMS

Merger Pacts: Contract Drafting, Cerberus Litigation

In terms of how efficiently they express the intent of the parties, contracts used in big-time mergers-and-acquisitions deals are dysfunctional. It's time to think about fixing them.

What prompted this thought is Chancellor William B. Chandler III's opinion in *United Rentals Inc. v. RAM Holdings Inc.*,[1] the case commonly known as "the Cerberus litigation."

Background

United Rentals Inc. (URI) is an equipment-rental company. RAM Holdings Inc. and RAM Acquisition Corp. were acquisition vehicles controlled by funds and accounts affiliated with Cerberus Capital Management LP, the private-equity buyout firm.

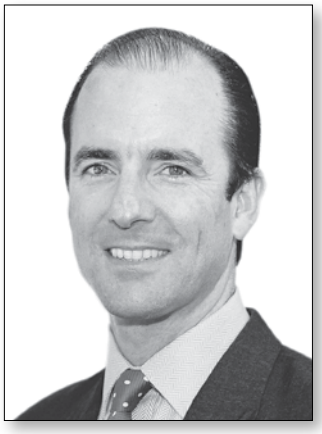
URI sued the RAM entities for having walked from a $6.6 billion deal to acquire URI. The RAM entities claimed that URI couldn't force them to consummate the merger and that under the merger agreement URI was entitled to only a $100 million breakup fee.

Chancellor Chandler found in favor of the RAM entities, and his opinion explores the shortcomings of the merger agreement. At issue was the interplay of two provisions. They're too long to quote in full, so "Sidebar A" contains a boiled-down version of both provisions, designated §A and §B.

URI's Argument

URI argued that under §A it was entitled to specific performance—it was entitled to force RAM to consummate the merger.

The first sentence of §B would appear to say that the breakup fee is URI's only remedy. But URI argued that the breakup fee only served as the exclusive remedy on termination and that neither side had terminated the agreement.



Sidebar

Below are stylized versions of §9.10 and §8.2(e) of the merger agreement between URI and the RAM entities. The text in italics is verbatim.

A. URI is entitled to specific performance to enforce the RAM entities' obligations under this agreement. This §A is subject to §B.

B. Notwithstanding §A, URI's right to terminate the agreement in specified circumstances and its right to receive the breakup fee will be URI's only remedy for any damages it suffers as a result of that termination. Whether this agreement has been terminated or not, the RAM entities and related entities will not be liable for any damages in excess of the breakup fee *and in no event shall [URI] seek equitable relief or seek to recover any money damages in excess of such amount from [the RAM entities and related entities].*

The second sentence of §B would appear to say that URI isn't entitled to equitable relief. But URI argued that the closing modifier "in excess of such amount" modified not only the phrase "seek to recover any money damages" but also went further back up the sentence and modified the phrase "seek equitable relief," meaning that URI was only precluded from seeking equitable remedies that include monetary damages in excess of the breakup fee. URI argued that this reading was required because otherwise this sentence would render §A devoid of meaning.

URI also argued that if the RAM entities had wanted to eliminate URI's rights to specific performance in all circumstances, they could have simply stricken §A.

The RAM Entities' Argument

For its part, the RAM entities argued that if the parties had intended that operation of §B would apply only if the merger agreement had been terminated, it would have been redundant to say in §A that the specific performance provisions of §A were subject to §B—specific performance wouldn't have been available in those circumstances, as one cannot specifically perform an agreement that has been terminated.

The RAM entities also argued that it would be unreasonable to limit the phrase "equitable relief" to those equitable remedies that include monetary damages.

The Holding

The court concluded that the arguments offered by URI and by the RAM entities were both reasonable as a matter of law, so summary judgment would be inappropriate.

Instead, the court considered extrinsic evidence to ascertain what the parties had intended. URI bore the burden of demonstrating that the parties had intended

Kenneth A. Adams *is a lecturer at the University of Pennsylvania Law School and author of "A Manual of Style for Contract Drafting" (ABA 2d ed. 2008 forthcoming). His Web site is www.adamsdrafting.com.*

that URI would be entitled to specific performance. Based on its review of the evidence, the court held that URI had failed to meet that burden. More specifically, the court held that URI knew or should have known that Cerberus thought it had an option to acquire URI; if URI had disagreed with that understanding, it should have made its position clear to Cerberus.

URI Drafting Failures?

During negotiations, a party to a contract may or may not succeed in making its position clear to the other party. The purpose of a contract is to resolve any uncertainty on that score, and in that regard the merger agreement between URI and the RAM entities has to be rated a failure. Let's consider what the lawyers might have done differently in terms of drafting appropriate language or revising language drafted by the other side.

It's not clear that URI's lawyers could have done much to ensure that the provisions clearly had the meaning sought by URI. For one thing, the current language of §B does tie the breakup fee to termination. The problem wasn't with the language so much as the idea. It seems unduly narrow.

And URI's lawyers could have structured the second sentence of §B to make it clear that the restriction was on equitable relief in the form of monetary damages, but here too it's the underlying idea, couching equitable relief only in terms of monetary damages, that seems problematic.

So from URI's perspective, the problem went beyond drafting. That being the case, it's not surprising that the court found in favor of the RAM entities.

RAM Entity Drafting Failures?

By contrast, if §A had been deleted, the RAM entities would have been spared the lawsuit. And lawyers for the RAM entities could have insisted that the contract express a more sensible regime for payment of the breakup fee, rather than tying it to termination. They also could have structured the second sentence of §B so as to preclude the interpretation that URI sought.

Explaining Failure

In negotiations with Cerberus, URI was represented by Simpson Thacher; their presence at the table indicates that this was high-stakes M&A. They prepared the first draft of the merger agreement. Cerberus was represented by Lowenstein Sandler, a well-known New Jersey law firm.

So how did it come to pass that the lawyers failed to produce an agreement that reflected a meeting of the minds on so important an issue? One could ascribe it to lawyer error and move on. But the temptation is to look for broader explanations. Two have been offered, one in the context of the Cerberus litigation and one more generally.

• ***'Consistent with Customary Practices.'*** One response might be that the drafting was in fact consistent with customary practices of M&A lawyers. In an expert report that the RAM entities submitted to the court, Professor John C. Coates offered, among other things, some observations on how M&A lawyers use "subject to" and "notwithstanding."[2] The RAM entities presumably intended that this report would address why lawyers for the RAM entities hadn't simply asked that §A be deleted rather than using "notwithstanding" and "subject to" to indicate that §B took precedence over §A.

As they revise agreements to reflect negotiations, deal lawyers tend to build new structures on top of the old instead of clearing away the debris. That might be more discrete, but it makes confusion much more likely.

Use of "notwithstanding" or "subject to" to indicate precedence of one provision over another is as a general matter not simply unobjectionable—it's an indispensable drafting tool. (In any given context you need only use one usage or the other, not both, and "subject to" is much the preferable of the two.)[3]

But to leave in a contract a provision that has ostensibly been entirely nullified by another provision is simply asking for trouble. As they revise agreements to reflect negotiations, deal lawyers tend to build new structures on top of the old instead of clearing away the debris. That might be more discrete, but it makes confusion much more likely.

In this regard, the following rhetorical question has been posed by way of defending the drafting of Cerberus' lawyers: "Who knows what would have happened if [Cerberus' lawyers] tried to make the change by deleting rather than trumping?"[4] Well, for one thing, the parties wouldn't have ended up in court.

• ***'The Confusion Was Intentional.'*** If you accept that the contract failed to express a meeting of the minds, one possible explanation is that one side or the other, or both, either ignored or created the confusion so as to get the deal done, with the idea that any lingering disagreements would be resolved in litigation.

Sidestepping a contentious contract issue with the notion of working it out in litigation is certainly a standard gambit. (Chancellor Chandler acknowledged as much.)[5] But it seems unlikely that that's what happened in this case. For one thing, sorting out the breakup fee was a crucial, do-not-pass-go issue rather than something to be resolved once the dust had settled post closing. And the conventional way to incorporate uncertainty in a contract is not through inconsistency but through vagueness, for example by means of a "material adverse change" provision. Some see strategy in incoherence,[6] but a simpler explanation for confused drafting is confused lawyers.

A More Likely Culprit

A more straightforward explanation comes to mind for the shortcomings in the merger agreement between URI and the RAM entities.

If you read through the portions excerpted in Chancellor Chandler's opinion, you'll find many of the problems that afflict mainstream contract drafting—stodgy lawyerisms, overlong sentences, awkward structure, overuse of "shall," needless rhetorical emphasis, redundant synonyms, buried verbs, recycled urban legends, needless elaboration, unhelpful use of the passive voice…

A single such infelicity would likely be trivial. But if, as in this case, they occur in great number and variety, they envelop the reader in a fog. It shouldn't come as a surprise that, as they groped their way through the murk, the lawyers failed to notice that something was seriously amiss.

In this regard, the URI merger agreement is entirely representative of mainstream contract drafting—all that distinguished it was the dollars involved. Contract parties routinely find themselves in court as a result of seemingly minor drafting problems.[7] And such disputes are the tip of the iceberg. What doesn't get any headlines but is ultimately more draining is the vast amounts of time and money wasted in drafting contracts the

traditional way, with traditional language. When you give any piece of mainstream drafting an overhaul, the difference is dramatic.[8]

Many lawyers might dispute this, offering the standard justifications:clear drafting entails "dumbing down," and drafters have to stick with dysfunctional language because it's been "tested" by the courts. These rationales were debunked long ago.[9]

What About Substance?

Whatever the shortcomings of contract language, one can rest assured that the substance is as it should be. Then again, perhaps not: in a recent sponsored article,[10] Robert A. Profusek and Lyle G. Ganske, co-chairs of Jones Day's M&A practice, in effect suggest that deal-making has become a sterile exercise in scrivening, and that instead lawyers should focus on what really matters in a deal.

So if you take into account both language and substance, it would seem that many M&A lawyers work long hours producing bloated, vastly inefficient documents that don't adequately address client needs and contain glitches that every so often land people in court. It's not a pretty picture.

The Remedy

In their article, Profusek and Ganske refer to a multifirm "initiative to rethink deal documentation fundamentally," the goal being to "come up with standardized base documents, and common language, that can be used in any transaction, whether it's a merger, a loan, or a capital markets event."

The notion of such an approach isn't new. And it makes sense. For one thing, it's unlikely that any one law firm would be willing to commit, even if it could, the considerable resources required to develop and maintain a broad set of comprehensive templates. And using templates becomes vastly more efficient if you have buy-in from both sides to a transaction. Furthermore, given the amounts at stake in big deals, one could readily justify the cost of putting in place the necessary infrastructure.

Increasing the Odds

But law-firm contract-template projects invariably die a lingering death. For an ambitious template system to work, it would have to allow lawyers to produce contracts much more quickly and efficiently. The contracts produced would have to be of state of the art. And the system would have to be centralized and rigorously maintained.

There are three ways you could greatly increase the odds of such an initiative succeeding:

• ***First,*** establish a rigorous house style for all template language. That's the only way to ensure that it's consistent and efficient. Any attempt to do without would be doomed to mediocrity and, in all likelihood, failure.

• ***Second***, outsource to a proven expert in contract language the bulk of the work of developing templates rather than allocating it among a group of law firms. For one thing, you'd want to avoid at all cost the dead hand of drafting by committee. And the expediency of the deal-maker is very different from the more measured approach required to produce state-of-the-art contract drafting. Law firms wouldn't be surrendering any meaningful autonomy, as contract language has largely been commoditized. The only question is whether you want it to be a high-quality commodity.

• ***And third,*** automate the templates with DealBuilder, the leading document-assembly software. (***Disclosure:*** I have a relationship with Business Integrity, the developer of DealBuilder.) Users would prepare first drafts by answering an online questionnaire, complete with annotations and links to authorities. The questionnaire could include optional language to address all but the more unusual permutations. The end result would be vastly more efficient and sophisticated than that old standby, a Word document annotated with footnotes and alternative language in brackets. And lawyers would finally be able to focus on strategy and negotiation rather than scrivening.

The Prospects for Change

Law firms could readily put in place a system of the sort described above. But law firms are notoriously resistant to change, and there's no reason to expect that lawyers would voluntarily abandon the current ramshackle system for drafting contracts. It has served them well. But it's clients who foot the bill. They've long been indulgent in that regard, but some of them appear to be getting restive. They want their outside counsel to provide better value and work smarter.

One modest sign to that effect is Wal-Mart's moratorium on across-the-board rate increases for legal services. Another is the way companies such as Tyco and Linde Group have elected to consolidate their scattered legal work in a single law firm.

It would take more of this sort of client activism to change how law firms draft contracts and to thereby avoid, among other things, train wrecks like the Cerberus litigation. Let's see what happens.

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1. 3360-CC, 2007 Del. Ch. LEXIS 181 (Del. Ch. Dec. 21, 2007).

2. See Kenneth A. Adams, "More on United Rentals Versus Cerberus—'Notwithstanding' and 'Subject To,'" AdamsDrafting Blog (Dec. 26, 2007) (available at http://adamsdrafting.com/system/2007/12/26/more-on-uri-versus-cerberus/).

3. See Kenneth A. Adams, A Manual of Style for Contract Drafting 9.35 (2004).

4. Jeffrey Lipshaw, "The Cerberus Case and Lessons in Law, Society, and Language," Concurring Opinions Blog (Dec. 22, 2007) (available at http://www.concurringopinions.com/archives/2007/12/the_cerberus_ca.html).

5. *United Rentals Inc.*, at *91.

6. See Felix Salmon, "The Upside of Sloppy Drafting," Market Movers Blog (Dec. 11, 2007) (available at http://www.portfolio.com/views/blogs/market-movers/2007/12/11/the-upside-of-sloppy-drafting).

7. See Kenneth A. Adams, "'Wordsmithing,'" NYLJ, June 21, 2007.

8. See, e.g., Kenneth A. Adams, "ABA 2007 Annual Meeting (Including My Panel-Discussion Materials)," AdamsDrafting Blog (Aug. 12, 2007) (available at http://adamsdrafting.com/system/2007/08/12/aba-2007-annual-meeting/) (providing links to annotated "before" versions of two contract extracts and redrafted "after" versions).

9. See Adams, supra note 3, at 1.5-6; Kenneth A. Adams, "The Concept of 'Tested' Contract Language," AdamsDrafting Blog (June 12, 2006) (available at http://adamsdrafting.com/system/2006/06/12/the-concept-of-tested-contract-language/)

10. Robert A. Profusek & Lyle G. Ganske, "It's Time to Rethink the Lawyer's Role in Dealmaking: Start by Facing Up to the New Realities," Metropolitan Corp. Couns., December 2007, at 33.