

THE FAILURE OF PRIVATE EQUITY

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Abstract

Throughout the Fall 2007 and into the new year 2008 private equity firms repeatedly attempted to terminate pending acquisitions. The litigation surrounding these purported terminations and heightened scrutiny directed upon the terms of private equity agreements opened a revealing window on a number of supposed "flaws" in the private equity structure. This Article seeks to understand whether these failures existed, and if so, what caused them. It does so by examining the forces driving the construct and evolution of private equity and the rationale for private equity's structure and specific contractual terms. I find that the private equity structure to be a rich, textured environment. The terms of the contractual relationship between the private equity firm and the acquired company are analogous to an iceberg; they form only the publicly available view of a much deeper understanding between the parties. In the non-public sphere, parties to private equity contracts utilize norms, conventions, reputational constraints, language and relational bonding to fill contractual gaps, override explicit contractual terms, and achieve a negotiated solution beyond the four corners of the contract. The attorney as transaction cost engineer in the private equity context consequently structures the private equity contract by paying heed both to contractual terms and law, contractually created forces and non-legal factors. But attorney reliance on these extra-contractual factors and forces makes the private equity structure path dependent and resistant to change. In light of these findings, the failures of the pre-Fall 2007 private equity structure were particularly a failure by attorneys for acquired companies to innovate and negotiate terms in full contemplation of such events. Reliance upon extra-legal forces permitted these attorneys to negotiate facially flawed private equity contracts and otherwise justified

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sloppy and ambiguous drafting.

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INTRODUCTION

The Fall of 2007 was a tumultuous time in the U.S. capital markets. A conflux of factors, including the implosion of the subprime mortgage market, created a financial maelstrom disrupting the economy and causing the credit markets to “dry-up” and become increasingly illiquid.¹ Almost overnight credit became both more expensive and difficult to obtain as financial institutions such as investment and depository banks became increasingly unwilling to extend new credit.² The credit securitization market was particularly affected leaving these financial institutions with pending financing obligations and existing loans they could sell, if at all, only at a large loss.³

¹ See Roben Farzad, et al., *Not So Smart, In an era of easy money, the pros forgot that the party can't last forever*, BUSINESSWEEK, Sep. 3, 2007; Phil Izzo, *Economists in Poll Expect Credit Turmoil to Continue*, THE WALL ST. J., Nov. 15, 2007, at A.

² See Antony Currie & Dwight Cass, *Ominous Crunching*, THE WALL ST. J., Nov. 2, 2007, at C; Eric Dash, *Debt Markets Looks to Feds to Ease Fear*, THE N.Y. TIMES, Sep. 18, 2007, C.

³ Leveraged loans securitized by CLOs together with high yield debt were the primary tools utilized by private equity firms to finance the debt component of their acquisitions. See *infra* Part I.A. In the credit markets at the time, large loans were typically securitized and sold to third parties as collateralized loan obligations (CLOs). This allowed financial institutions to transfer these loans off their balance sheets and make new loans with the proceeds from the sale. If the CLO market was unavailable it hampered the ability of these financial institutions to extend new loans. In addition, the closing of the CLO market left these financial institutions with loans extended and agreed to be extended that could either not be sold or sold only at a loss. See Floyd Norris, *Sickly Credit Markets Heal a Little as Leveraged Loans Rebound*, THE N.Y. TIMES, Oct. 6, 2007, C3.

Facing large losses, these institutions began to balk at funding pre-agreed private equity acquisitions.⁴ This sudden, unexpected turn of events and the general revaluation and decline in stock prices it wrought led private equity firms to reassess their pending acquisitions agreed to in more stable times.⁵ The private equity firms' reevaluations were often unkind. Throughout the Fall and into the new year 2008 private equity firms in a number of previously agreed acquisitions repeatedly attempted to terminate their contractual obligations to acquire companies.⁶

In such instances, the private equity firms largely successfully relied upon the negotiated language in their contracts to terminate their pending acquisitions or agree a settlement to the same effect.⁷ In many instances litigation ensued before such disposition. The litigation surrounding these terminations and heightened scrutiny directed upon the terms of private equity agreements opened a revealing window on the practices of parties and attorneys in negotiating and structuring private equity transactions. Under the public glare, the intricate structures of these transactions appeared to be fundamentally flawed or otherwise the product of "suboptimal" structuring and contracting.⁸ Observers particularly criticized acquirees for agreeing to optional takeover structures; the inclusion of reverse termination fee provisions which permitted private equity firms to terminate the acquisition for any reason simply by paying a flat fee of approximately 3% of the transaction value.⁹ A blame-game unfolded and fault for these failures was alternatively pinned on financial institutions, investment bankers, private equity firms, acquiree boards and acquiree attorneys.¹⁰

This Article is an examination of the structure of these private equity transactions and the role of lawyers, particularly those representing acquirees, in its negotiation and documentation. It seeks to understand the forces driving the evolution of the private equity structure, the rationale for

⁴ The term private equity as used in this Article refers to the acquisition of both public and private companies by investment entities utilizing a leveraged financing structure. The term is sometimes used on a more general basis to refer to an investment in any private company including venture capital investments. See generally Gail Marmorstein et al., *Hidden Treasure: A Look Into Private Equity's History, Future, And Lure*, J. WEALTH MGMT, at 2 (Sum 1999).

⁵ See Ken MacFadyen, *Avoiding the Messy Breakup: Amid the turmoil produced by the credit crunch, some PE investors are dealing with a case of acquirers' remorse*, INV. DEALERS' DIG., Sept. 10, 2007.

⁶ I discuss this wave of private equity transaction terminations *infra* at Part II.

⁷ See *infra* at Part II.

⁸ I discuss these notions further *infra* at Part IV.D.

⁹ See, e.g., Steven M. Davidoff, *Where Do Breakup Fees Go From Here?*, N.Y. TIMES DEALBOOK, Apr 7, 2008, available at <http://dealbook.blogs.nytimes.com/2008/04/07/where-do-breakup-fees-go-from-here/>.

¹⁰ [This author participated on one such panel entitled "Who is To Blame?" before the Merger, Acquisitions & Split-offs class taught by Professor Robert Clark and Vice Chancellor Strine at Harvard Law School.]

the structure and its contractual terms and whether the pre-August 2007 private equity structure was indeed a “suboptimal” or “flawed” one. I look to answer these questions through an examination of litigation transcripts, interviews with industry participants and research on a database of 192 private equity contracts and other public records.

I find that the private equity bargain, including the contract implementing the private equity structure, is a rich, textured environment. The terms of the contractual relationships between the private equity firm and the acquired company are partly analogous to an iceberg; they form only the publicly available view of a much deeper understanding between the parties. In the non-public sphere, parties to private equity contracts and their lawyers utilize norms, conventions and outside constraints to fill contractual gaps, override explicit contractual terms, and achieve a negotiated solution beyond the four corners of the contract. In this world, negotiating attorneys have their own discourse on contract language, particularly with respect to open terms, which oftentimes differ from judicial interpretation of the terms they utilize.¹¹ The contract is merely the starting point for analyzing the negotiated understanding of the parties. In the private equity structure though, the contract still has a very real and valid purpose. It outlines the relationship of the parties, and documents their agreement to the extent feasible creating a bonded relationship to affect future conduct. This is a world where parties and their attorneys do not necessarily leave terms ambiguous for future litigation or negotiating purposes.¹² Rather, the contract functions as a fulcrum for further private bonding, interpretation, negotiation and agreement after execution of the acquisition agreement.¹³

In the private equity structure, though, contract terms do play an important, flexible role throughout the relationship. Flipping the iceberg on its head – the contract is not the endpoint but rather the foundation and start for an understanding among the parties. Contract matters from the beginning in the private equity structure. The picture painted has much to offer in terms of further understanding and judicial interpretation of complex contracts; a topic I will explore in a companion paper to this one.¹⁴

¹¹ See Lawrence M. Solan, *Contract as Agreement*, 83 NOTRE DAME LAW REVIEW 353 (2007).

¹² See B. Douglas Bernheim & Michael D. Whinston, *Incomplete Contracts and Strategic Ambiguity*, 88 AM. ECON. REV. 902 (1998); Claire Hill, *Bargaining in the Shadow of the Lawsuit* (2008) (unpublished manuscript on file with author). I discuss this further *infra* at notes 209-210 and accompanying text.

¹³ See also Sergio G. Lazzarini et al., *Order with Some Law: Complementarity Versus Substitution of Formal and Informal Arrangements*, 20 J. L. ECON. ORG. 261, 261 (2004) (“[B]y enforcing contractible exchange dimensions, contracts facilitate the self-enforcement of noncontractable dimensions.”)

¹⁴ This companion paper will examine the implications of my findings for current contract theory. Ultimately, the failure and structure of private equity lend support to relational contract theory, but also show that the contract terms and the negotiation thereof have important, key roles in contract. This has follow-on

This is a world that Professor Lisa Bernstein and Professor Stewart Macaulay, who have extensively written on social norms and their role in establishing extra-legal business relationships, would not find surprising.¹⁵ But the findings of this article's study differ from their research and other research on relational and private contracting which at best has viewed the contract as relevant merely in the "end game" after the relationship has failed and the parties are in dispute.¹⁶

The attorney as transaction cost engineer in the private equity context consequently structures the private equity contract by paying heed both to contractual terms and law, contractually created forces and non-legal factors.¹⁷ The attorney measures the weight of each of these and adjusts contracts terms and transaction structure in response. However, these extra contractual forces can incentivize lawyers to avoid innovating. The structure of private equity is thus path dependent.¹⁸ It results from "good enough" structuring decisions made by transactional attorneys who are under-incentivized to innovate.¹⁹ Change in the private equity structure is intermittent, caused by externalized forces and results in piece-meal

implications for the neoformalists and those who advocate for less "law" in judicial interpretation of contracts. See *inter alia* Eric A. Posner, *Law, Economics, and Inefficient Norms*, 144 U. PA. L. REV. 1697 (1996); Eric A. Posner, *A Theory of Contract Law Under Conditions of Radical Judicial Error*, 94 NW. U. L. REV. 749 (2000); Robert E. Scott, *The Case for Formalism in Relational Contract*, 94 NW. U. L. REV. 847 (2000). The neoformalists have argued that the judiciary is constitutionally incapable in a complex business environment of providing useful default rules, determining the true meaning of parties or otherwise imposing appropriate judgment *ex post facto*. Accordingly, courts should interpret contracts literally. As support for this the neoformalists have claimed that parties can simply adjust their conduct after any such judgment. See Alan Schwartz, *Incomplete Contracts*, in *THE NEW PALGRAVE DICTIONARY OF ECONOMICS AND THE LAW* (Peter Newman ed. 1998); Alan Schwartz, *Relational Contracts in the Courts: An Analysis of Incomplete Agreements and Judicial Strategies*, 21 J. LEGAL STUD. 271 (1992). This case study of private equity lends support to the neoformalist view. I discuss this further at *infra* note 291.

¹⁵ See *inter alia* Lisa Bernstein, *Opting Out of the Legal System: Extralegal Contractual Relations in the Diamond Industry*, 21 J. LEGAL STUD. 115 (1992); Lisa Bernstein, *Private Commercial Law in the Cotton Industry: Creating Cooperation Through Rules, Norms, and Institutions*, 99 MICH. L. REV. 1724 (2001); Stewart Macaulay, *Non-Contractual Relations in Business: A Preliminary Study*, 28 AM. SOCIO. REV. 1 (1963). They would not be alone – the two have inspired a raft of further scholarship on this topic.

¹⁶ See Lisa Bernstein, *Merchant Law in a Merchant Court: Rethinking the Code's Search for Immanent Business Norms*, 144 U. PA. L. REV. 1765, 1800-01 (1996) ("the terms of a written contract are viewed as relevant primarily when transactors have decided not to deal again, that is, when their relationship is at an end-game"); Claire A. Hill & Christopher King, *How Do German Contracts Do as Much with Fewer Words?*, 79 CHI.-KENT L. REV. 889 (2004). Neoformalist contract doctrine has similarly focused on the contract as primarily relevant in the end-game of the contractual relationship. See Robert E. Scott & Paul B. Stephan, *Self-Enforcing International Agreements and the Limits of Coercion*, 2004 WIS. L. REV. 551, 597.

¹⁷ The concept of the transactional attorney as a transaction cost engineer, negotiating transaction structure and terms to create value, net of legal fees, was first prominently put forth by Professor Ronald J. Gilson. See Ronald J. Gilson, *Value Creation by Business Lawyers: Legal Skills and Asset Pricing*, 94 YALE L.J. 239, 243 (1984).

¹⁸ I discuss the meaning of path dependency further *infra* at notes 223-225 and accompanying text.

¹⁹ This proposition that forces push lawyers towards "good enough" decisions is one first brought to my attention in the scholarship of Professor Claire A. Hill. See Claire A. Hill, *Why Contracts are Written in "Legalese"*, 77 CHI.-KENT L. REV. 59, 71 (2001). See also John C. Coates, IV, *Explaining Variation in Takeover Defenses: Blame the Lawyers*, 89 CAL. L. REV. 1301, at 1308-24 (2001) (examining the forces which affect attorney decisions at the IPO stage which provide "lawyers with sufficient autonomy that they determine their clients' pre-IPO defenses, largely unconstrained by market forces or ethical rules").

revisions premised upon the pre-existing structure.

Moreover, the private equity legal universe is a small, self-contained one. From January 1, 2004 through August 1, 2007, the same 22 law firms represented a acquiree or private equity acquirer in 91.06% of all public private equity deals.²⁰ Given that these law firms repeatedly represent private equity firms but only represent acquirees on a one-off basis, these firms may not be fully incentivized to negotiate innovative, beneficial provisions for acquirees. While this may not have been the determining factor in the failure of the private equity structure, it likely contributed to the forces working against innovation and reinforcing path dependency.²¹ Reliance on extra-contractual legal forces additionally allowed attorneys to hide this possible bias.

Notions of transactional “optimality” in the private equity structure are thus relative: the structure of private equity cannot be characterized as an efficient one due to these constraints which create path dependency and hamper innovation. These are not Coasian bargains.²² Illustratively, in the wake of the events of Fall 2007, attorneys reweighed the balance of contract terms and law versus non-legal forces and the structure of private equity and private equity contracts terms rapidly shifted to accommodate the host of litigation and failed transactions.²³ The path dependency of private equity, though, still hampered creative solutions that would permit private equity to actively compete in the transformed marketplace.

This Article speaks to the failure of private equity contract and its structure. But there were multiples failures of private equity in this past year. The private equity boom of 2004 through July 2007 occurred against the backdrop of a vast credit bubble. During that time credit was freely available at extraordinarily low interest rates. Financial institutions rushed head-long to finance private equity acquisitions at rates that in hindsight were severely mispriced.²⁴ In this environment private equity firms themselves took advantage of this easy and available credit to pay attractive

²⁰ See Chart IV.C. *infra*.

²¹ I discuss the underpinnings of my belief further *infra* at Part IV.C.

²² Of course, Coase himself acknowledges that transaction costs can inhibit or forestall Coasian bargaining. See Ronald H. Coase, *The Problem of Social Cost*, 3 J. OF LAW AND ECON. 1 (Oct. 1960).

²³ See *infra* at Part V.A.

²⁴ In other words, the interest rates charged by these financial institutions did not reflect the possible risks associated with a future default by the acquired company on the credit extended. Moreover, the banks extended too much financing resulting in over-leverage of these acquisitions. See, e.g., *Great Phrases in History: Irrational Exuberance. ‘Incontinent’ Investing?*, WSJ DEAL JOURNAL, <http://blogs.wsj.com/deals/2008/10/07/great-phrases-in-history-irrational-exuberance-incontinent-investing/>, Oct. 7, 2008.

prices and make a record number of acquisitions.²⁵

In hindsight, the companies who agreed to be acquired by private equity firms and who were so acquired made the right decision. The shareholders of these acquired companies received a price far above the current trading level of the stock market. Meanwhile, private equity firms acquired a vast portfolio of companies at low interest rates, flexible credit terms and with minimum money invested. The bulk of the funds used for these acquisitions was again provided by banks who were willing to accept smaller equity investments from private equity firms.²⁶ Against this macro-picture, the failure of private equity was a failure of financial institutions to properly price their loans and financial instruments.²⁷ This particular failure is part of a broader credit one that has had astounding economic implications for our world economy.

This Article touches on these issues and provides an explanatory history of the private equity market and its mechanisms, but this Article's focus is on a more particular failure: the actual private equity transactions which failed to complete. As such, it is a story of the failure of lawyers, particularly lawyers for acquirees, and private equity contracts. And it is a wider case study of how lawyers negotiate contracts, contract functions in a particular industry, path dependency can exist even in sophisticated environments and extra-legal norms and conventions can fail. Here, this Article aims to fill an increasingly noted gap in the contracts literature.²⁸ There has been much theoretical discourse but little research into how clients and their attorneys negotiate and agree to complex contracts in either continuing or discrete relationships.²⁹ Finally, this study has importance for other studies on contract evolution and boiler-plate which have tended to label terms as efficient or suboptimal based on the pure text of contracts without looking to extra-legal understandings and practices of the parties.³⁰ If indeed the contract is only part of the agreement of the parties, these studies may be incomplete.

²⁵ See Justin Baer & Edward Evans, *Wall Street bankers wonder how big leveraged buyouts can get*, Bloomberg, Apr 3, 2007.

²⁶ For example, the amount of debt provided to Kohlberg Kravis Roberts to purchase First Data exceeded its market capitalization in the week prior to the acquisition.

²⁷ See Speech of Jane Wheeler, Penn M&A Institute, Nov. 25, 2008 (copy on file with author).

²⁸ See generally Brayden King and Gordon D. Smith, *Contracts as Organizations* (Mar. 2007). University of Wisconsin Legal Studies Research Paper No. 1037 available at SSRN: <http://ssrn.com/abstract=969816>. See also Nicholas S. Argyres et al., *Complementarity and Evolution of Contractual Provisions*, 18 *Org. Sci.* 3, 3 (2007); Stewart Macaulay, *Contracts, New Legal Realism, and Improving the Navigation of the Yellow Submarine*, 80 *TUL L. REV.* 1161, 1186-82 (2006).

²⁹ See generally King and Smith, *supra* note 28 (surveying the limited number of contract studies).

³⁰ See *infra* notes 218-216 and accompany text.

Part I of this Article examines the historical evolution of the private equity contract and structure. Part II details the very public Fall 2007 failure of these contracts. Part III examines more particularly the structure of private equity and its alleged individual failures as well as the negotiation process for these transactions. Part IV details the path dependency of the private equity structure and the role of attorneys, particularly those for acquirees, in perpetuating the structure. Part V concludes with a discussion of the response of market participants to the failures of private equity and their implication for the future structure of these transactions.

I. THE STRUCTURE OF PRIVATE EQUITY

The structure of private equity is largely a product of its unique financing. Private equity pervasively utilizes substantial leverage to purchase public and private corporations. Private equity firms typically borrow 60%-80% of the required purchase price and obtain the remaining necessary capital from pre-committed investors who provide equity for this purpose.³¹ In order to enhance their returns and increase the number of purchased companies, private equity seeks to place as much debt and as little equity as feasible into the acquisition capital structure.³² Private equity is therefore significantly dependent upon the nature of debt financing and the availability of credit. If credit is more freely available and at lower interest rates, this permits private equity firms to borrow more money to make increased acquisitions at higher prices paid to acquired companies. Because of this, the structure of private equity over the years has evolved, driven in large measure by the type and availability of financing.

A. *The Origins of the Private Equity Structure*

The foundations of today's private equity structure were laid in the 1970s and 1980s.³³ A beginning occurred in 1976 when Jerome Kohlberg and first cousins Henry Kravis and George Roberts created the first true

³¹ These pre-committed equity investments are often supplemented by additional side-by-side equity investments by co-investors. See JOSHUA LERNER, ET AL., VENTURE CAPITAL AND PRIVATE EQUITY: A CASEBOOK, at [●] (4th Ed. 2008).

³² Placing more debt on a company enhances the possible returns to the equity investors because any subsequent profit from selling the acquired company is returned on a smaller equity investment. Private equity consistently places significantly more debt on its acquisitions than ordinary public companies. The reasons for this differential are uncertain but can possibly be attributed to the uncertainty of cash flows and the heightened risk increased leverage places on a company, a risk that public companies are not as willing to bear. See Ronald J. Gilson & Charles K. Whitehead, *Deconstructing Equity: Public Ownership, Agency Costs, and Complete Capital Markets*, 108 COLUM. L. REV. 231 (2008).

³³ See GEORGE P. BAKER & GEORGE DAVID SMITH, THE NEW FINANCIAL CAPITALISTS: KOHLBERG KRAVIS ROBERTS AND THE CREATION OF CORPORATE VALUE 53-56 (1998); BRYAN BURROUGH AND JOHN HELYAR, BARBARIANS AT THE GATE: THE FALL OF RJR NABISCO 133-36 (1990).

private equity firm Kohlberg, Kravis & Roberts Co.³⁴ The trio at KKR raised the industry's first equity fund in 1978.³⁵ This provided a pre-arranged source of committed equity capital. However, at this time debt for acquisitions was still raised on an *ad hoc* basis and was largely limited to secured credit financing from bank lenders.³⁶ If private equity was to grow, a steady source of debt financing was required which would permit a larger amount of debt to be incurred for acquisitions.

This source would be pioneered by the brilliant and infamous Michael Milken and the firm he worked for, Drexel Burnham Lambert. Throughout the 1970s and 1980s, Michael Milken and his colleagues at Drexel had been working to create a larger market for high yield debt, often derogatorily known as junk bonds.³⁷ This debt was often referred to as junk because this debt was either unrated or rated below investment grade and was subordinated to other senior more highly rated debt.³⁸ Historically, high yield debt was shunned by investors and utilized by small issuers who had fewer financing choices.³⁹ Milken had studied this market and found that investors in this debt had historically realized extraordinary returns.⁴⁰ He popularized this finding and soon convinced many institutional and other investors to purchase the high yield debt offerings Drexel underwrote.⁴¹ Milken needed an even larger supply of issuers of these securities to fulfill the demand he had largely created.

In private equity Milken found a large source; from the mid-1980s private equity acquisitions became one of the principal issuers of high yield securities.⁴² Private equity firms during this time would use traditional senior secured loans together with high yield and other debt-type securities to increase the debt level on individual acquisitions.⁴³ The additional funds provided by this high yield financing allowed private equity to make larger and more frequent company purchases.⁴⁴ It would be the nature of this debt

³⁴ See Allen Kaufman and Ernest J. Englander, *Kohlberg Kravis Roberts & Co. and the Restructuring of American Capitalism*, 67 Bus. Hist. Rev. 52, 67-68 (1993).

³⁵ *Id.* at 71. See also GEORGE ANDERS, *MERCHANTS OF DEBT: KKR AND THE MORTGAGING OF AMERICAN BUSINESS* (1992).

³⁶ See Brian Cheffins & John Armour, *The Eclipse of Private Equity*, at 17 (Apr 2007), available at <http://ssrn.com/abstract=982114>.

³⁷ DANIEL R. FISCHER, *PAYBACK: THE CONSPIRACY TO DESTROY MICHAEL MILKEN AND HIS FINANCIAL REVOLUTION* (1995).

³⁸ See PATRICK A. GAUGHAN, *MERGERS, ACQUISITIONS, AND CORPORATE RESTRUCTURINGS* 330 (3rd ed., 2002); Scott P. Mason and Bill Hildebolt, *History and Analysis of the High-Yield Debt Market*.

³⁹ FISCHER, *supra* note 37, at [*].

⁴⁰ See CONNIE BRUCK, *THE PREDATOR'S BALL: HOW MICHAEL MILKEN AND HIS JUNK BOND MACHINE STAKED THE CORPORATE RAIDERS* (1988).

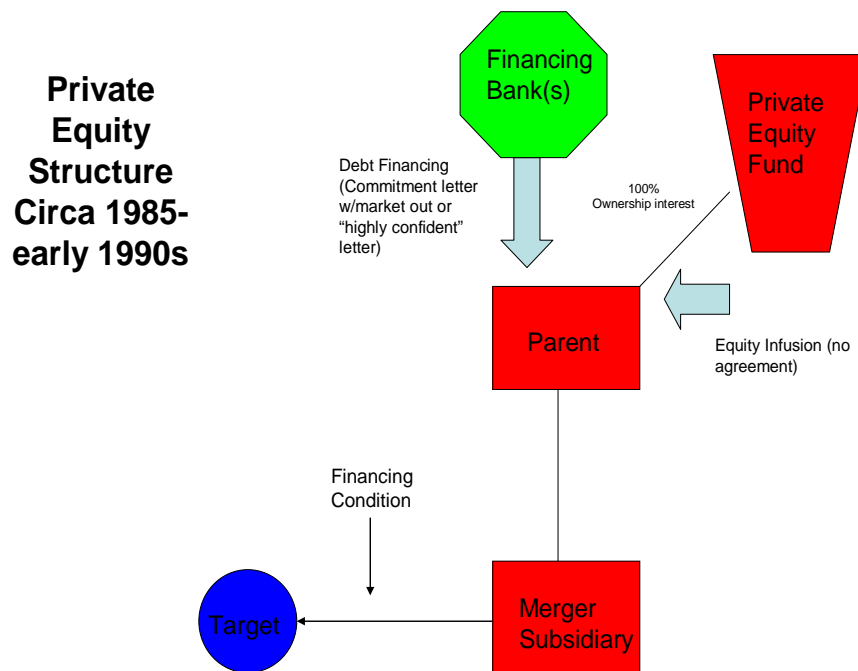
⁴¹ *Id.* at [*].

⁴² See BURROUGH & HELYAR, *supra* note 33, at [*]; Cheffins & Armour, *supra* note 36, at 17.

⁴³ *Id.*

⁴⁴ See Kaufman & Englander, *supra* note 34, at 76-79.

financing, and the needs of the investment banks underwriting or originating it, that would drive the structure of private equity acquisitions. The structure most commonly used in the 1980s through the 1990s can be diagrammed as follows:

Chart 1A⁴⁵

In the above structure the private equity buy-out was effected by thinly capitalized shell subsidiaries set up specifically for this purpose by the private equity firm (Parent and Merger Subsidiary in the above diagram).⁴⁶ The shells had no substantial assets of their own. Instead, the acquisition agreement required that the shells use a measure of “best efforts” to complete the transactions contemplated by the agreement.⁴⁷ Since the shells had no real assets, companies to be acquired (Acquiree in the above diagram) demanded assurances that the financing would be available. So, these arrangements were also typically accompanied by a debt financing commitment letter from an investment and possibly commercial bank (Financing Bank in the above diagram).⁴⁸ The banks would provide senior bank credit facilities, but would also act as underwriters for selling any high yield debt in the market and for any other offering.⁴⁹

Importantly, the debt commitment letter was not a binding arrangement

⁴⁵ See RJR Nabisco Holdings Corp. Registration Statement on Form S-1, dated 1989.

⁴⁶ The fund uses separate shell subsidiaries to effect this acquisition in order to limit its liability among other reasons.

⁴⁷ See, e.g., *id* at [•].

⁴⁸ See BURROUGH & HELYAR, *supra* note 33, at [•].

⁴⁹ See BRUCK, *supra* note , at [•].

to provide funds, rather the debt commitment letter was an agreement to negotiate definitive financing arrangements on the terms set forth in the commitment letter.

In addition, the commitment letter was executed at the time the acquisition agreement was executed. The final documentation was not signed until the transaction completed some months later. It was at this time that the banks would extend any loans and attempt to sell the high yield debt to finance the acquisition.

However, because there was this period between the signing of the acquisition agreement and completion of the transaction, there was substantial risk for the banks. The banks had agreed to extend this credit under terms set forth in the commitment letter. If market conditions changed or interest rates fluctuated in the wrong direction, the banks would still be obligated to fund under the old terms set forth in the commitment letter. In such a case, when the banks went to sell the debt issued in connection with the transaction they might have to charge a lower price for it than expected when the agreements were first signed, thereby incurring a loss. In extreme circumstances they might be unable to sell the debt entirely leaving them stuck holding the entire financing package.

To address this issue, the banks typically negotiated commitment letters which contained a “market out” clause, a clause which permitted the banks to terminate their financing obligations if market conditions deteriorated or otherwise impeded placement or incurrence of the debt.⁵⁰ Due to the high leverage on these transactions, banks were often unwilling to even provide this level of commitment. In such circumstances, the banks would issue a “highly confident” letter.⁵¹ These letters were pioneered by Drexel Burnham in financings where the success of the debt issuance was too uncertain to provide any firm written commitments.⁵² The financing banks would instead opine that they were “highly confident” that the debt could be raised in the markets but provide no contractual agreement to do so.⁵³

In either case, though, the private equity fund itself was not liable if the transaction failed to close. Due to the uncertainty of the debt financing, private equity firms refused to commit themselves to entirely fund the

⁵⁰ See David J. Sorkin & Eric M. Swedenburg, *Recent Developments in Financing-Related Provisions in Leveraged Buyouts*, at 1-2 (Jan. 2006), available at http://lawprofessors.typepad.com/mergers/files/simpson_jan_2006_client_memo.pdf

⁵¹ See BRYAN BURROUGH & JOHN HELYAR, *BARBARIANS AT THE GATE: THE FALL OF RJR NABISCO* (2003).

⁵² See BRUCK, *supra* note , at [*].

⁵³ See BRUCE WASSERSTEIN, *BIG DEAL : 2000 AND BEYOND* (2000).

acquisition if the debt financing failed.⁵⁴ Acquirees typically agreed to this demand. Since the private equity firms had no contractual obligation to fund the acquisition, this effectively provided private equity firms with an ability to exit from the buy-out any time before consummation of the acquisition for any reason even beyond failure of the debt financing. The acquisition agreement also permitted the shell to terminate the agreement if financing was unavailable. This was accomplished by placing a financing condition in the acquisition agreement, conditioning the shell's obligation to acquire the acquiree on the shell having obtained sufficient financing to do so.⁵⁵

B. The Shifting Structure of Private Equity

In the 1990s the private equity structure continued to evolve in response to market forces. Acquirees began to contractually bind the private equity firms themselves. They did this by demanding and receiving equity commitment letters from the private equity firms' sponsoring fund.⁵⁶ These letters obligated the fund to supply the shells with the necessary equity to complete the transaction. This filled the equity gap in financing these transactions, providing a contractual commitment for the shell subsidiaries to access the necessary equity component of their financing. The debt commitment letter was thus paired with an equity commitment letter. Notably, this new mechanism placed the first real limitation on the ability of private equity firms to exit transactions – the equity commitment letter now contractually bound the private equity firm's fund to provide the shell subsidiary the equity investment in the acquisition. During this time period, the terms of debt commitment letters also shifted. The principal change in these letters was the inclusion of bridge financing.⁵⁷ Bridge financing is interim financing between the completion of the transaction and the placement of any permanent debt financing.⁵⁸ The addition of bridge financing thus provided increased certainty to the acquiree that the transaction would be completed if the offering of any of the permanent debt was delayed.

⁵⁴ The equity capital was the share ownership stake and together with debt financing typically consisted of the bulk of the funds used to purchase the acquiree.

⁵⁵ See Sorkin & Swedenburg, *supra* note 50, at 2.

⁵⁶ *Id.* The prior absence of this equity commitment is attributable to the origins of private equity. Initially in the late 1970s and early 1980s private equity firms largely funded the equity component of the transaction through syndication begun after the transaction announcement. See, e.g., Transaction Documents for Gibbons Greeting; Coca Cola Bottling of New York. An equity commitment letter was inappropriate at that time since there yet was any equity to be committed and the parties who would commit the equity were still unknown.

⁵⁷ See *Bridge Loans Make A Comeback*, CORPORATE GROWTH REP., Aug. 14, 1995, at 7987; *A New Generation of Bridge Lending*, MERGERS & ACQUISITIONS, Sept./Oct. 1994, at 6.

⁵⁸ See Nancy H. Wolitas, et al, *Financing Options for Issues Related to Leveraged Buy-Outs* in FOURTH ANNUAL PRIVATE EQUITY FORUM: LEGAL & FINANCIAL STRATEGIES FOR DEALMAKING IN THE CURRENT MARKET, at 456-57 (PLI Instit. Oct.-Dec. 2002).

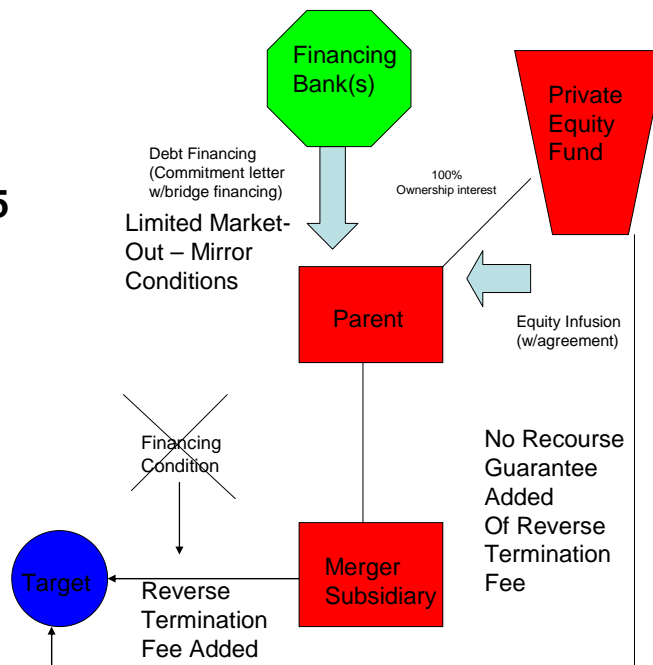
The structure of private equity deals further evolved in the new millennium.⁵⁹ A significant shift in transaction structure was triggered by the March 2005 \$11.3 billion buy-out of SunGard Data Systems by a private equity consortium.⁶⁰ The SunGard transaction was structured as follows:

⁵⁹ I discuss the reasons for this shift *infra* at Part IV.

⁶⁰ See Andrew Ross Sorkin, *Private Investment Firms to Pay \$11.3 Billion for SunGard Data*, THE N.Y. TIMES, Mar 28, 2005. See also Martin Sikora, *LBO Funds Offer Incentives To Drive High-Priced Deals: Groups propose "reverse" breakup fees, dropping the financing out while angling for SunGard and Neiman Marcus buys*, M&A: THE DEALMAKERS' J. Sept. 1, 2005 (describing the SunGard transaction as "a major shift from traditional leveraged dealmaking").

Chart 1B⁶¹

SunGard Structure Circa 2005



Comporting with the prior historical structure, the equity portion of the transaction was set forth in an equity commitment letter executed by the private equity firms' funds.⁶² The debt portion of the transaction was agreed through a commitment letter by five investment banks and included a bridge financing facility.⁶³ SunGard also negotiated the removal of the financing condition from the main agreement between SunGard and the private equity consortium. In addition to negotiating the deletion of a financing condition, SunGard was able to obtain a debt commitment letter which had conditions reciprocal to those in the acquisition agreement. In other words, if the conditions to the acquisition agreement were satisfied so would the debt commitment letter conditions. By better aligning the terms of the debt commitment letter and the main acquisition agreement, the financing for the transaction was more certain if the conditions in the main agreement were fulfilled. Finally, the SunGard debt commitment letter contained a limited "market out" and "lender out".⁶⁴ The result was a transaction structure

⁶¹ This chart was prepared from information contained in the SunGard Definitive Proxy Statement on Schedule 14A, at 49-54 (June 27, 2005), available at <http://www.sec.gov/Archives/edgar/data/789388/000119312505131157/ddef14a.htm> [hereinafter SUNGARD PROXY STATEMENT].

⁶² *Id.* at 49-50.

⁶³ *Id.* at 50-53.

⁶⁴ In the words of two prominent practitioners, "a 'Lender [out]' occurs, for example, in the event that the lending sources are prohibited from funding due to legal prohibitions or lender insolvency." See Sorkin & Swedenburg, *supra* note 50, at 3.

more favorable to the acquiree since completion was contractually more certain.⁶⁵ Importantly, though, by agreeing to a more certain debt commitment letter and providing bridge financing, the banks now took on the risk of a market deterioration in between the time of the signing of the transaction and the closing. If the value of the debt declined during this time period, the banks would suffer the loss. This would appear to be a rational decision in 2005 and the days of easy credit, but it would be a decision that would turn out to savagely haunt these financial institutions.

In exchange for agreeing to the removal of the financing condition in the main agreement, SunGard also agreed to a cap on the private equity consortium's maximum liability for breach of the acquisition of \$300 million and a bar on specific performance in the acquisition agreement.⁶⁶ In other words, if the shell was unable to complete the buy-out because the financing arrangements failed or otherwise because it refused to do so, i.e., the agreement was intentionally breached, the private equity funds only liability was to pay a fee of \$300 million to SunGard as compensation. The fee was called a reverse termination fee because it was patterned upon termination fees that acquirees typically agreed in acquisition agreements to pay acquirers if they subsequently accepted a higher offer from another bidder. The reverse termination fee in the SunGard transaction amounted to three percent of the transaction value and was the same amount as the termination fee.⁶⁷ And since the shells were still that, empty corporations without substantial funds, the private equity funds issued a guarantee for this payment.⁶⁸

This type of structure had previously been utilized in other transactions, but apparently not in private equity deals.⁶⁹ The SunGard "structure" was the first private equity transaction of any significance to employ such architecture.⁷⁰ After SunGard the structure quickly took hold in private equity transactions. The following chart sets forth my own calculations as to the percentage of private equity deals utilizing a reverse termination fee structure from 2004 through 2008:

⁶⁵ See *infra* notes 178-179 and accompanying text.

⁶⁶ See SUNGARD PROXY STATEMENT, *supra* note 61, at 91.

⁶⁷ *Id.*

⁶⁸ *Id.* at 54.

⁶⁹ These included the buy-outs of Extended Stay America, Prime Hospitality, Boca Resorts, Wyndham International and La Quinta Corporation.

⁷⁰ Email from Alan Fishbein, dated Sept. 10, 2008.

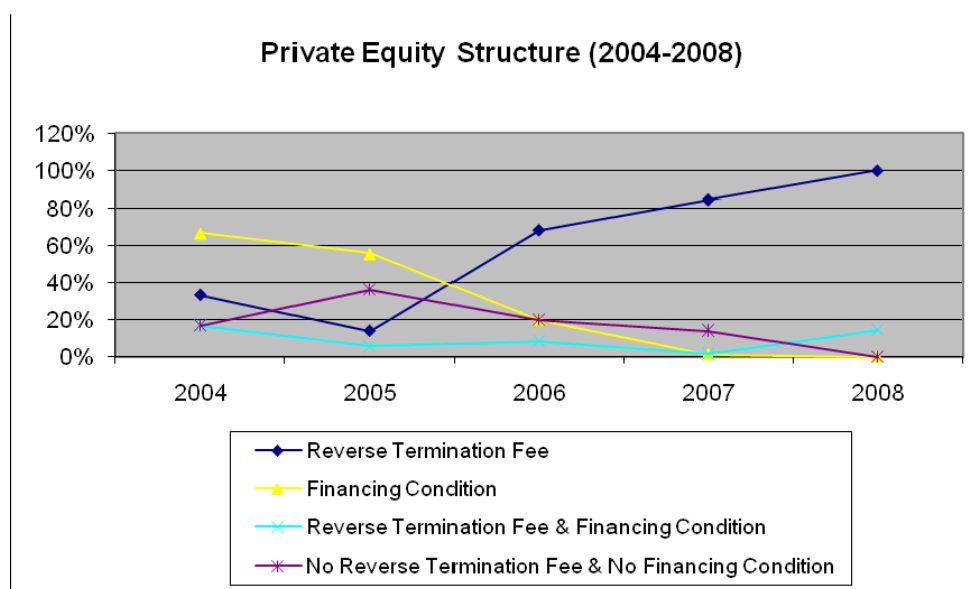
Chart 1C⁷¹

Chart 1C shows a rapid shift in practice as the use of financing conditions in acquisition agreements dropped in inverse proportion to utilization of the reverse termination fee structure. The reverse termination fee became the norm in private equity acquisitions, but this structure sometimes varied depending upon the agreement of the parties. For example, in the 2005 private equity buy-out of Neiman Marcus, the private equity acquirers agreed to a two-tiered termination fee.⁷² A lower fee would be paid if the private equity fund breached the agreement and failed to complete the transaction due to a failure of financing. A higher fee phrased as a cap on the private equity consortium's maximum liability would be paid if the private equity fund willfully breached the agreement and refused to complete the transaction when all of the conditions to completion, including financing, were satisfied. A third variation of this arrangement arose in other buy-outs, such as that of Penn National Gaming, where the acquiree could under the terms of the contract force the private equity shells to specifically perform and enforce the debt and equity commitment letters to complete the transaction.⁷³ If for some reason the debt or equity financing

⁷¹ Author calculations based on data provide by Mergermetrics (Search data on file with author). Information is only for announced public private equity deals greater than \$100 million in value and for which a transaction document was available.

⁷² The Neiman Marcus Group Inc. Definitive Proxy Statement on Schedule 14A, at 67-68 (July 18, 2005), available at <http://www.sec.gov/Archives/edgar/data/819539/000119312505143823/ddefm14a.htm> [hereinafter NEIMAN MARCUS PROXY STATEMENT].

⁷³ The Penn National Gaming, Inc. Definitive Proxy Statement on Schedule 14A, at 90-91 (Nov 7, 2007), available at <http://www.sec.gov/Archives/edgar/data/921738/000119312507238601/0001193125-07-238601-index.htm>

became unavailable then termination of the agreement and receipt of the reverse termination fee was the acquiree's only remedy.

In its first two variations, this arrangement provided a flat-out ability to the private equity firm to exit a transaction simply by paying the reverse termination fee. The third was supposed to be a more certain structure for acquirees because so long as the debt and equity commitment letters were enforceable, the private equity funds could not simply "walk" on a transaction. Rather, the acquiree could go to court to force the shell subsidiaries to enforce and draw on the debt and equity commitment letters to complete the acquisition. Finally, the Neiman Marcus transaction was notable for completely eliminating the "market-out" in debt commitment letters, a change to the structure that would persist in its variations.⁷⁴

The reverse termination fee structure in its variations was the blueprint of private equity heading into Summer 2007. I will discuss the reasons for this shift in structure *infra* at Part IV, but before I do it is necessary to first talk about the events of Fall 2007 and onward.

II. THE FAILURE OF PRIVATE EQUITY

The structure of private equity appeared to have achieved a new equilibrium after a significant transformatory period from 2005-2007. Lawyers in private equity transactions had leveraged the increased willingness of lenders to provide more flexible terms to renegotiate the boiler-plate of private equity. However, the credit crisis ensuing in the summer of 2007 and subsequent events over the course of the following year would expose flaws in this structure. In this Part II, I discuss the events of the summer of 2007 and afterwards. These would be the mother of all shocks to the structure of private equity. The ensuing events would reveal not only the inherent problems with the private equity structure, but would open up a further window into the manner of negotiation of these complex contracts and their evolution.⁷⁵

A. *The Failure of Contract*

The first public signs of a significant disruption in the takeover markets emerged in late July and early August of 2007. During that period acquirers in two significant public takeover transactions, the pending acquisitions of

⁷⁴ See NEIMAN MARCUS PROXY STATEMENT, *supra* note 72, at [•].

⁷⁵ See Steven M. Davidoff, *Private Equity's Option to Buy*, M&A LAW PROF, Aug. 16, 2007, available at <http://lawprofessors.typepad.com/mergers/2007/08/private-equitys.html>

Accredited Home Lenders and Radian, attempted to terminate their acquisition agreements. Each of these acquirers invoked a material adverse change (MAC) clause in the agreement to do so.⁷⁶ A MAC clause provision is a clause in an acquisition agreement which permits an acquirer to refuse to complete the transaction if a material and adverse change as defined in the acquisition agreement occurs to an acquiree prior to the time of completion of the acquisition.⁷⁷ The invocation of these clauses in these two instances was a sign that market and economic turbulence was beginning to affect takeover transactions. However, these two, first MAC claims were confined to the industries most relevantly affected by the summer subprime mortgage crisis – both of the affected acquiree companies Accredited Home Lenders and Radian were in the subprime lending business.⁷⁸ Moreover, both of these transactions utilized a non-private equity acquisition structure. Rather, each was structured in the traditional strategic manner and did not have a financing out or a reverse termination fee provision, were backed fully by the assets of the acquirer, and provided for specific performance of the transaction.⁷⁹

But as August progressed, stock market volatility increased and the credit markets became increasingly illiquid, public attention turned to the \$[•] billion in pending private equity transactions.⁸⁰ In light of the disruption in this market a number of public commentators and news sources began to report on the private equity reverse termination structure, questioning the willingness of private equity firms to complete these acquisitions. The first prominent news piece was published in the N.Y. Times on August 21, 2007 and was entitled “Can Private Equity Firms Get Out of Buyouts?”⁸¹ The article, by Andrew Ross Sorkin, highlighted the reverse termination fee structure now common-place in private equity buyouts, explored the willingness of private equity acquirers to terminate these transactions, and discussed the reputational constraints on their ability to do so.⁸²

⁷⁶ These four transactions were the proposed takeovers of Accredited Home Lenders, the home supply unit of Home Depot, Inc., SLM Corp. and Radian.

⁷⁷ Wei Lingling, *Accredited Home Sues Lone Star to Save Deal*, THE WALL ST. J., Aug 14, 2007, at C; Paul Gores, *MGIC sues merger partner for data Subprime crisis prompts mortgage insurer's lawsuit*, MIL. J. SEN., Aug 22, 2007, at D.

⁷⁸ See Steven M. Davidoff & Kristen Baiardi, *Accredited Home Lenders v. Lone Star Funds: A MAC Case Study* (Feb. 11, 2008). Wayne State University Law School Research Paper No. 08-16 Available at SSRN: <http://ssrn.com/abstract=1092115>.

⁷⁹ See *supra* note 77.

⁸⁰ Pali Capital Arbitrage Situations (Jul 31, 2007).

⁸¹ Andrew Ross Sorkin, *Can Private Equity Firms Get Out of Buyouts?*, THE N.Y. TIMES, Aug 21, 2007. See also Steven M. Davidoff, *Private Equity's Option to Buy*, Aug 16, 2007, at <http://lawprofessors.typepad.com/mergers/2007/08/private-equitys.html>.

⁸² *Id.*

During August and through mid-November, private equity firms in two pending public transactions with reverse termination fee structures did indeed attempt to terminate acquisitions agreed prior to the summer credit crisis. These involved the buy-outs of Acxiom and Harman.⁸³ However, the acquirers did not invoke the reverse termination fee provisions negotiated in their transaction agreements. Rather, these private equity acquirers asserted real or ostensible MAC claims to terminate their obligations.⁸⁴

They did so for at least three reasons. First, the deterioration in the markets and general economy provided a colorable basis to make this assertion. Second, a MAC claim provided reputational cover; instead of being labeled as “walking” on their contractual obligations, a MAC claim provided historically legitimate grounds for an acquirer to terminate the transaction; it is generally perceived as acceptable for a acquirer to invoke a MAC.⁸⁵ Finally, a MAC claim provided negotiating leverage to the private equity firm. Under the terms of each of these agreements, if the private equity firm was successful in claiming a MAC it could terminate the agreement without any required payment to the acquiree.⁸⁶ Moreover, the maximum liability of the private equity firms if their MAC claim failed was capped at the reverse termination fee.⁸⁷ The assertion of a MAC in combination with a reverse termination fee provision thus provided the private equity firms with negotiating leverage by setting their maximum liability in any settlement or litigation.⁸⁸

Both of these MAC claims were ultimately settled through an agreement among the parties which terminated the acquisition agreement.⁸⁹ The legitimacy of these MAC claims and the dynamic created by the interaction of these claims with the reverse termination fee was revealed by the amounts the private equity firm ultimately paid to the acquirees to terminate

⁸³ See generally Paul S. Bird, *Deals Redefined*, THE DAILY DEAL, Dec. 19, 2007.

⁸⁴ See *id.* See also Michael De la Merced, *When a Deal is no longer a Deal*, THE N.Y. TIMES, Sept 24, 2007.

⁸⁵ See Andrew Ross Sorkin, *After the Party*, THE N.Y. TIMES, Oct 3, 2007.

⁸⁶ See Agreement and Plan of Merger by and among Axio Holdings LLC, Axio Acquisition Corp. and Acxiom Corporation, Dated as of May 16, 2007 available at <http://www.sec.gov/Archives/edgar/data/733269/000073326907000018/ex2-1mergeragmt.htm> (Section 8.1) [hereinafter ACXIOM AGREEMENT]; Agreement and Plan of Merger among KHI Parent Inc., KHI Merger Sub Inc., and Harman International Industries, Incorporate, Dated as of April 26, 2007 available at <http://www.sec.gov/Archives/edgar/data/800459/000095013407009341/d45945exv2w1.htm> (Section 7.01) [hereinafter HARMAN AGREEMENT]. See also Kelly Holman, *Big MAC Attack? Material adverse change' clause getting more attention*, INV'T DEALERS' DIGEST, Oct 1, 2007.

⁸⁷ See ACXIOM AGREEMENT, *supra* note 86, at Section 9.8; HARMAN AGREEMENT, *supra* note 86, at Section 7.02. Compare this with the MAC claim in Accredited Home Lenders at the same time. In that deal the parties renegotiated the transaction

⁸⁸ Interview with Acxiom General Counsel. Jerry C. Jones, Oct 10, 2007.

⁸⁹ See Kelly Holman, *Breaking Up is (Less) Hard to Do: PIPE-like deal resolves Harman dispute*, INV. DEALERS' DIG., Oct 29, 2007.

the transaction. In each case the payment was near to the reverse termination fee amount.⁹⁰ Thus, in this early Fall period private equity firms could be seen as attempting to avoid reputational tarnish by asserting MAC claims to avoid being viewed as invoking the reverse termination fee provisions. The validity of these MAC claims was belied by the amounts privately negotiated and paid by the private equity firms; the settlement approximated the reverse termination fee. The result was beneficial to the private equity firms – it may have protected their reputation -- but their actions left acquirees publicly damaged by these claims of an adverse event to their business. In most of these cases this also left the acquirees' stock prices trading below their price prior to the announcement of the acquisition agreement.⁹¹

B. The Failure of Norms

In Federalist Paper Number 15, Alexander Hamilton observed that reputation is a “less active influence” constraining behavior when a nefarious deed is done by many.⁹² Hamilton’s observation aptly applies to the events surrounding the Fall 2007 wave of private equity acquisition terminations. Initially, no single private equity firm was willing to stain its reputation and harm its competitive position in the buy-out market by invoking a reverse termination fee provision. Instead, these firms asserted MAC claims to publicly justify termination and avoid being labeled as “walking” on their transactions and an untrustworthy future acquirer. However, as the Fall progressed the reputational forces on private equity firms to complete buy-outs became diluted as the credit markets remained illiquid and the number of terminated private equity deals increased. The reputational impact was diluted.⁹³

This prominently evidenced itself on November 14, 2007 when the private equity fund controlled by Cerberus attempted to terminate its

⁹⁰ The Acxiom agreement provided for a two-tiered reverse termination fee. However, the MAC clause invocation permitted the private equity firm to treat it as a failure of financing to force a settlement in an amount equal to 97.38% of the lower reverse termination fee. See Interview, *supra* note 88; Acxiom Press Release, October 10, 2007 available at http://www.acxiom.com/72451/Acxiom_Release. In Harman the \$200 million reverse termination fee was invested into the company as part of a \$400 million investment in connection with the termination of the agreement to be acquired. See Harman Press Release, *KKR And GS Capital Partners To Invest In Harman International*, Oct 22, 2007, available at http://www.harman.com/press/financial_press.aspx?st=.

⁹¹ See Elizabeth Nowicki, *Private Equity Deals of 2007: Lessons To Learn*, at 5 (2008) (unpublished draft on file with author) (listing the post-termination declines in stock prices of private equity acquirees in failed transactions).

⁹² Alexander Hamilton, Federalist Paper No. 15, *The Insufficiency of the Present Confederation to Preserve the Union For the Independent Journal*.

⁹³ See Karen Donovan, *Private Equity: Breaking Up Is Not That Hard to Do*, Portfolio.com, Dec. 27, 2007, available at <http://www.portfolio.com/views/blogs/daily-brief/2007/12/27/private-equity-breaking-up-is-not-that-hard-to-do> (“Private-equity firms, meanwhile, seem to be saying: Reputation? What reputation? Here’s a \$100 million and watch me walk away.”)

agreement to acquire United Rentals.⁹⁴ Cerberus did not assert a MAC to justify its action. Rather, the shell subsidiaries owned by Cerberus and who were the parties to this agreement simply invoked the reverse termination provision in the acquisition agreement.⁹⁵ Cerberus argued that this provision permitted it to terminate its obligations for any reason upon payment of a \$100 million reverse termination fee.⁹⁶ Cerberus had decided that any reputational impact was overcome by the declining economic return of the transaction. In assessing the reputational damage Cerberus was no doubt influenced by prior private equity terminations and their dilutive effect on any such reputational loss.⁹⁷

United Rentals sued the Cerberus shell subsidiaries in Delaware Chancery Court challenging their attempt to terminate the agreement.⁹⁸ United Rentals argued that the contract provided for United Rentals to require specific performance of the shell subsidiaries obligations.⁹⁹ In other words, the parties' dispute centered upon the type of reverse termination fee structure they had negotiated, the pure reverse termination fee or specific performance structure. United Rentals argued that this contract provided for specific performance of the shell subsidiary entities financing commitments. Only if the financing then failed could the entities terminate the agreement.¹⁰⁰ The Cerberus shell entities argued that the same language of the contract barred specific performance and that their only liability was for \$100 million.¹⁰¹ The suit was complicated by the fact that the acquisition agreement was governed by Delaware law and had a Delaware choice of forum clause while the guarantee provided by the Cerberus fund of the shell entities' obligations was governed by New York law and had a New York choice of forum clause.¹⁰² The Cerberus fund leveraged this disjunction to bring a separate suit in New York for declaratory relief that the separate

⁹⁴ See United Rentals Current Report on Form 8-K, dated Nov. 14, 2007, available at <http://www.sec.gov/Archives/edgar/data/1067701/000101905607001167/0001019056-07-001167-index.htm>

⁹⁵ *Id.*

⁹⁶ See Schedule 13D/A filed by RAM Holdings, Inc., dated Nov. 14, 2007, at 2, available at <http://www.sec.gov/Archives/edgar/data/1067701/000090571807000317/united13dam1.txt>

⁹⁷ See Donovan, *supra* note 93; Andrew Ross Sorkin, *If Buyout Firms Are So Smart, Why Are They So Wrong?*, THE N.Y. TIMES, Nov. 18, 2007.

⁹⁸ See *United Rentals Inc. v. RAM Holdings Inc. and RAM Acquisition Corp.*, dated Nov. 19, 2007, available at http://lawprofessors.typepad.com/mergers/files/URI_complaint.pdf. See also Matthew Karnitschnig and Lingling Wei, *Economy Conspires to Dog Cerberus United Rentals Sues Over Collapsed Deal; Chrysler Loans Stall*, THE WALL ST. J., Nov. 20, 2007, at C1.

⁹⁹ See *United Rentals, Inc. v. RAM Holdings, Inc., et al.*, 937 A.2d 810, 830-31 (Del. Ch. 2007).

¹⁰⁰ *Id.*

¹⁰¹ *Id.* at 832-833.

¹⁰² See Steven M. Davidoff, *Cerberus Sues in New York*, M&A Law Prof (Nov. 23 2007), available at <http://lawprofessors.typepad.com/mergers/2007/11/cerberus-sues-i.html>. The reason for this is that bank finance documents have traditionally been governed by New York law while in this time period due to an adverse case decided under New York law, acquisition agreements were governed by Delaware law. The choice of forums followed from the choice of law. I discuss why lawyers could agree to such a disjunction *infra* at notes 250-254.

terms of its guarantee limited its liability to \$100 million.¹⁰³ The New York suit was never substantively litigated, though, as Chancellor Chandler, the judge in the Chancery Court, beforehand found that the contract language was ambiguous.¹⁰⁴ This case was ultimately a contract dispute, and Chancellor Chandler applied standard contract interpretation principles to hold in favor of Cerberus's reading of the agreement.¹⁰⁵ When United Rentals announced that it would not appeal this decision, Cerberus promptly terminated the acquisition agreement and paid United Rentals \$100 million.¹⁰⁶

The Cerberus/United Rentals dispute and Cerberus's subsequent termination of its agreement resulted in a further deterioration of the reputational force preventing exercise of a reverse termination fee provision. In the period from December through February, 2008 three additional private equity transactions would be effectively terminated, the pending acquisitions of PHH, Reddy Ice and Myers Industries.¹⁰⁷ In each case, no MAC claim was publicly asserted, but instead the acquirers merely exercised the reverse termination fee provision in its agreement to exit the transaction.¹⁰⁸ In each instance, the agreement clearly prohibited specific performance and permitted this action.¹⁰⁹ Thus by early 2008 the fundamental understandings of the parties in private equity agreements appeared to have fallen by the wayside and the inherent optionality in this type of a reverse termination fee structure realized. A reverse termination fee provision appeared to become exercisable without significant reputational impact or other external normative constraints.

¹⁰³ See Cerberus Partners, L.P., et al. v. United Rentals, Inc., No. 7603876 (Nov. 21, 2007).

¹⁰⁴ United Rentals, 937 A.2d at 834.

¹⁰⁵ Chancellor Chandler found the language of the contract to be ambiguous and therefore looked to the extrinsic evidence to find an objective, reasonable meaning of the contract language. The court then applied the forthright negotiator rule to find that United Rentals knew or should have known Cerberus's understanding of the contract and did not correct it. *Id.* at 834-843.

¹⁰⁶ See United Rentals, Inc. Current Report on Form 8-K, dated December 26, 2007, available at http://www.sec.gov/Archives/edgar/data/1047166/000101905607001342/ur_8k.htm.

¹⁰⁷ See PHH Corporation Current Report on Form 8-K, dated Jan. 7, 2008, available at <http://www.sec.gov/Archives/edgar/data/77776/000095012308000112/y46075e8vk.htm>; Reddy Ice Current Report on Form 8-K, dated Feb. 1, 2008, available at http://www.sec.gov/Archives/edgar/data/1268984/000110465908006289/a08-4392_18k.htm; Meyers Industries, Current Report on Form 8-K, dated Dec. 10, 2007, available at <http://www.sec.gov/Archives/edgar/data/69488/000006948807000074/form8k121007.htm>.

¹⁰⁸ *Id.*

¹⁰⁹ See Agreement and Plan of Merger by and among Myeh Corporation, Myeh Acquisition Corporation and Myers Industries, Inc., dated Apr. 24, 2007 available at <http://www.sec.gov/Archives/edgar/data/69488/000006948807000037/exhibit101.htm> (Section 8.4(f)); Agreement and Plan of Merger by and among PHH Corporation, General Electric Capital Corporation, and Jade Merger Sub, Inc., dated Mar 15, 2007 available at <http://www.sec.gov/Archives/edgar/data/77776/000095012307003874/y32034exv2w1.htm> (Section 9.10); Agreement and Plan of Merger by and among Frozen LLC, Hockey Parent Inc., Hockey Mergersub, Inc. and Reddy Ice Holdings, Inc., dated Jul 2, 2007, available at http://www.sec.gov/Archives/edgar/data/1268984/000110465907051661/a07-17958_1ex2d1.htm (Section 9.7(b)).

C. *The Failure of Specific Performance*

The economics and parameters of the pure reverse termination fee structure were largely redefined by the Fall wave of collapsed private equity acquisitions. By 2008 most of these deals had either been terminated or consummated in accordance with their terms. However, into the new year a number of significantly larger multi-billion dollar private equity transactions remained pending.¹¹⁰ The majority of these were structured utilizing a specific performance reverse termination fee structure rather than a pure reverse termination fee.¹¹¹ The closing of these transactions was delayed into the winter of 2008 due to regulatory or financing issues.¹¹² At the time many speculated that these deals remained outstanding in part due to their less “optional” structure: the provision of specific performance prevented the private equity firms from simply terminating the agreement unless financing became unavailable.¹¹³ Given that the acquirers couldn’t simply terminate their obligations, they instead waited, delaying the deal and hoping the credit and stock markets improved sufficiently to make the economics of their transactions again viable.

In the new year 2008 as the credit crisis continued and the economic cycle trended further downward, these transactions continued to be stressed by extrinsic shocks.¹¹⁴ The result was another wave of litigation, this time implicating the viability of this second form of private equity structure. The first of these disputes occurred at the end of January, 2008 and arose out of the pending sale of Alliance Data Services to funds affiliated with The Blackstone Group. At that time, it was disclosed that the Office of the Comptroller of the Currency was refusing to grant a required regulatory approval for ADS to be acquired by Blackstone.¹¹⁵ The OCC justified its refusal on the grounds that the post-acquisition leverage of ADS would leave ADS insufficiently capitalized to support its national bank subsidiary.¹¹⁶ The OCC did however express a willingness to reverse its

¹¹⁰ The backlog of pending U.S. private equity transactions as of January 9, 2008 was approximately \$108 billion. Pali Arbitrage Spreadsheet (excludes transaction less than \$100 million).

¹¹¹ The five biggest pending deals were Alliance Data Services, BCE, Clear Channel, Huntsman and Penn National Gaming. All but Clear Channel contained a specific performance form of the reverse termination fee structure.

¹¹² See generally Bill Barnhart, *Acquisitions, mergers follow natural course*, CHI. TRIB., Jan. 30, 2008.

¹¹³ See Steven M. Davidoff, *Who’s Next for the Deal Dead Pool?*, N.Y. TIMES DEALBOOK, Jan 10, 2008, available at <http://dealbook.blogs.nytimes.com/2008/01/10/whos-next-for-the-deal-dead-pool/>.

¹¹⁴ See Heidi N. Moore, *The Buyout Financing Backlog: Are We There Yet?*, THE WALL ST. J. DEAL J., Jan. 30, 2008, available at <http://blogs.wsj.com/deals/2008/01/30/the-buyout-financing-backlog-are-we-there-yet/> (reporting that the backlog of private equity-related debt remained at over \$250 billion as of January 2008).

¹¹⁵ See Michael J. de la Merced, *Deal to Buy Credit Card Processor Is in Peril*, THE N.Y. TIMES, Jan. 29, 2008.

¹¹⁶ See Complaint for Alliance Data Systems Corporation v. Aladdin Solutions, Inc. et al., Civil Action

position if the acquiring Blackstone fund itself provided a back-stop, uncapped guarantee of ADS's bank liabilities effective upon completion of the sale.¹¹⁷

ADS sued in Delaware Chancery Court to compel the Blackstone fund to provide this guarantee.¹¹⁸ In accordance with the boiler-plate of the specific performance reverse termination fee structure used at that time, ADS had negotiated an acquisition contract which provided that ADS could sue to force performance of the Blackstone shell subsidiaries' obligations under the agreement.¹¹⁹ This arguably included the subsidiaries' contractual obligation to use "reasonable best efforts" to obtain any necessary regulatory approvals, including OCC clearance, for the transaction.¹²⁰ ADS argued in court that the requirement to use "reasonable best efforts" by the shell subsidiaries required them to sue the Blackstone fund itself, their parent, to compel it to issue the OCC requested guarantee.¹²¹ Blackstone countered that ADS had only entered into the acquisition agreement with thinly capitalized shell subsidiaries, a fact which ADS was fully aware of at the time it entered into the agreement.¹²² The Blackstone fund's only obligation was under its equity commitment letter issued to these subsidiaries and its own guarantee of the reverse termination fee.¹²³ Therefore, the shell entities could not force the Blackstone fund to provide the OCC guarantee, and since these entities could not provide the guarantee required by the OCC the transaction could not be completed.¹²⁴

Blackstone's response highlighted a fundamental limitation of the specific performance form of private equity structure. The private equity shell subsidiaries are corporate limited liability entities whose only real assets are their financing commitments and agreement to acquire the acquiree. If regulators or other events require the shell subsidiaries to act beyond these assets, specific performance becomes meaningless since no assets are available. The agreement thus effectively becomes unenforceable

No. 3507-VCS, at ¶¶8-10, Jan. 29, 2008, available at <http://www.sec.gov/Archives/edgar/data/1101215/000129993308000505/exhibit2.htm> [hereinafter ALLIANCE DATA COMPLAINT].

¹¹⁷ *Id.*

¹¹⁸ *Id.* See also Michael J. de la Merced, *Credit Card Processor Sues Blackstone to Finish Buyout*, THE N.Y. TIMES, Jan. 31, 2008.

¹¹⁹ See Agreement and Plan of Merger by and among Aladdin Holdco, Inc., Aladdin Merger Sub, Inc. and Alliance Data Systems Corporation, Dated as of May 17, 2007, available at <http://www.sec.gov/Archives/edgar/data/1101215/000095013407011838/d46889exv2w1.htm> (Section 9.8.2).

¹²⁰ See Alliance Data Complaint, *supra* note 116, at ¶¶ 11-13.

¹²¹ See Hearing Transcript, Alliance Data Systems Corporation v. Aladdin Solutions, Inc. et al., Civil Action No. 3507-VCS, at 13-15, Feb. 4, 2008, available at <http://graphics8.nytimes.com/images/blogs/dealbook/ADSxscript.pdf> [hereinafter ADS HEARING].

¹²² *Id.* at 31-35.

¹²³ *Id.*

¹²⁴ *Id.*

unless the private equity fund voluntarily agreed to support any such arrangements.

ADS attempted to sidestep this dilemma by arguing that the “reasonable best efforts” clause in its acquisition agreement contemplated more, a fact that the parties were aware of at the time of the agreement’s negotiation.¹²⁵ The shell subsidiaries could be required under this clause to sue their parent Blackstone fund for any additional sums or contractual requirements required to satisfy regulatory demands. However, the meaning of “reasonable best efforts” under Delaware law had yet to be addressed substantively in any court and was therefore uncertain.¹²⁶ And Vice Chancellor Strine, the judge assigned to adjudicate ADS’s complaint, openly questioned ADS’s argument in a hearing; Vice Chancellor Strine correctly noted that the Blackstone fund was not contractually bound to provide the OCC demanded guarantee in this structure and so the grounds for any on-suit by the Blackstone subsidiaries against their parent would likely be slim.¹²⁷ In the wake of Strine’s comments and his apparent favorable view of Blackstone’s arguments, ADS withdrew its complaint. At the time ADS cited Blackstone’s public statements that it was still committed to completing the transaction as the reason for this withdrawal.¹²⁸

ADS’s statement upon withdrawing its suit illustrates another role of litigation in these disputes. In one strand of contract theory, forces push against litigation and towards private settlement due to the prohibitive costs of lawsuits.¹²⁹ But in the private equity context, the relative costs of litigation are low compared to the billions in value at stake.¹³⁰ Litigation thus served three purposes in the post-August private equity disputes. First, litigation provided a platform for each of the parties to further elaborate their private understandings of the contract and attempt to enforce them. Second, litigation served as a public forum to enforce reputational norms.¹³¹

¹²⁵ *Id.* at 13-15.

¹²⁶ A Westlaw search of the phrase “reasonable best efforts” in the Delaware case database revealed only eight cases even mentioning the term. None of them offered an interpretation of the meaning of the term.

¹²⁷ ADS HEARING, *supra* note 121, at 39-42.

¹²⁸ See Alliance Data Systems Current Report on Form 8-K, dated Feb. 8, 2008, available at http://www.sec.gov/Archives/edgar/data/1101215/000129993308000705/htm_25430.htm. Blackstone did not follow through on its public commitment. The agreement was subsequently terminated and the parties are now litigating in Delaware Chancery Court the issue of whether Blackstone is required to pay the \$170 million reverse termination fee. See Phil Milford, *Alliance Sues Blackstone for \$170 Million Fee in Dropped Buyout*, BLOOMBERG NEWS, May 31, 2008, available at <http://www.bloomberg.com/apps/news?pid=20601127&refer=law&sid=a54ZIHZ3jl2U>.

¹²⁹ See Hill, *supra* note 11.

¹³⁰ Given the centrality of these provisions and the low costs of drafting them, one common explanation – that the likelihood of litigation was low, was arguably not a factor in the private equity contract. *But see* Hill, *infra* note 207, at 54.

¹³¹ This is similar to the channeling theory of contracts – that parties use contracts to speak publicly about

For example, even though Blackstone had reverted to a formalistic view of the contract ADS was still attempting to invoke extra-contractual norms to complete the transaction. Despite ADS's apparently weak legal case, the company asserted in court that their litigation was about enforcing "a commitment from [Blackstone] in writing to close this [transaction] as expeditiously as possible [and] to enforce the agreement."¹³² This is also illustrated by a quote from the statement released by Huntsman upon being sued by Hexion, a company wholly owned by the private equity fund Apollo, to terminate their acquisition agreement in another private equity dispute:

Apollo's recent action in filing this suit represents one of the most unethical contract breaches I have observed in fifty years of business. Leon Black and Josh Harris [partners in Apollo] should be disgraced. Our company will fight Apollo vigorously on all fronts.¹³³

Litigation also provided a forum for the parties to obtain a quick assessment of the risks of an adverse judgment and pushed them towards resolution of their disputes. This was unique to private equity disputes and due to the overwhelmingly selection of Delaware in acquisition agreements as the forum for these disputes.¹³⁴ The Delaware courts have a reputation for speed and efficient adjudication and they obliged in these disputes, acting quickly to adjudicate them. Here, the Delaware judges also pushed the parties towards resolution of their disputes through their pre-trial opinions and public statements.¹³⁵ Illustratively, ADS's withdrawal of their suit was also likely influenced by Vice Chancellor Strine's negative comments on their case.

The ADS litigation ultimately exposed the limits of this structure in respect to its contractual terms. A second dispute involving the sale of Clear Channel's TV station business to Providence Equity Group would highlight the more direct difficulties of forcing the shell subsidiaries to enforce and draw upon their own financing commitments. The Clear Channel TV station dispute unfolded in litigation in two jurisdictions. Wachovia Bank sued the Providence Equity shell subsidiaries in a North Carolina court to terminate its obligations under its debt commitment letter to finance the subsidiaries'

their relationship. See Lon L. Fuller, *Consideration and Form*, 41 COLUM. L. REV. 799, 801-3 (1941). However, while this occurred in the private equity context, it largely failed to be effective.

¹³² See ADS HEARING, *supra* note 121, at 66.

¹³³ See Press Release of Huntsman, July 19, 2008, available at http://huntsman.com/eng/News/News/Huntsman_Rejects_Apollo_Attempt_to_Back_Out_of_Merger_Agreement/index.cfm?PageID=7379&News_ID=5800&style=328.

¹³⁴ See *infra* note 252.

¹³⁵ See Steven M Davidoff, *Battle-Testing Delaware*, THE N.Y. TIMES,

acquisition of the Clear Channel TV business.¹³⁶ In addition, uncertain as to Providence Equity's commitment to the transaction, Clear Channel sued the Providence Equity shell subsidiaries in Delaware Chancery Court to force them to litigate against Wachovia to enforce their debt commitment letter and equity commitment letter.¹³⁷ Both litigations were settled shortly after their filing in an agreement that included a reduction in the purchase price.¹³⁸ But a notable hearing before Vice Chancellor Strine highlighted the difficulty of forcing these shell subsidiaries to act when their parent refused to complete the transaction. Vice Chancellor Strine mused that in such circumstances a remedy of specific performance could set free the shell subsidiaries under the guidance of a special master.¹³⁹ The shell subsidiaries obligation to use reasonable best efforts to obtain financing would thus be interpreted to include a search to parties for financing and funds other than to the recalcitrant private equity firms.¹⁴⁰

. The Clear Channel TV Station case was settled before a ruling could be issued. This left open the scope and means of any specific performance remedy against shell subsidiaries in circumstances where the private equity fund parent refused to provide additional funds. The legal availability of specific performance in a cash transaction was still an uncertainty in many states, including Delaware.¹⁴¹ And the dual litigation in the Clear Channel TV Station dispute due to the disharmony in the forum selection clauses in the financing documents and acquisition agreement raised the real possibility that the structure could completely collapse.¹⁴² In other words, not only could the private equity firm but the financing banks could breach their financing commitment letters. This would create a situation where a acquiree would be forced to sue the shell subsidiaries and through some type of judicially ordered mechanism arrange a suit on behalf of the subsidiaries against the banks and/or private equity firms to obtain necessary financing. And the suits would have to be in different

¹³⁶ See Andrew Ross Sorkin & Michael J. de la Merced, *Bank's Suit May Hurt Deal for Clear Channel Unit*, THE N.Y. TIMES, Feb. 25, 2008.

¹³⁷ *Id.*

¹³⁸ See Andrew Ross Sorkin & Michael J. de la Merced, *Lawsuit Is Settled Over Sale of Clear Channel's TV Unit*, THE N.Y. TIMES, Mar. 15, 2008.

¹³⁹ Hearing in Clear Channel Broadcasting, Inc., et al. v. Newport Television LLC, No. 3550-VCS, at 80-81, dated Feb. 26, 2008, available at <http://lawprofessors.typepad.com/mergers/files/bd022682.ecl.pdf>.

¹⁴⁰ *Id.*

¹⁴¹ Specific performance is a remedy granted only when monetary damages are inadequate. Vice Chancellor Strine had granted specific performance of a cash acquisition in the seminal case of *IBP v. Tyson*. However, practitioners still speculated that this case might be unusual and therefore specific performance still inappropriate under Delaware law since the damages on a cash transaction were ascertainable in monetary terms. See Kevin Miller, *URI's Request for Specific Performance: The Elephant in the Room*, at <http://www.deallawyers.com/blog/archives/000838.html>, Dec. 4, 2007.

¹⁴² The reason for this dichotomy is that bank financing arrangements have historically been governed by New York law; and since 2005 private equity agreements largely by Delaware law. I discuss the failure to harmonize these clauses *infra* at 250-253 notes and accompanying text.

jurisdictions due to the differing forum selection clauses. While an acquiree could theoretically perform such acrobatics, the structure appeared to be collapsing under its own weight at this point.

D. The Failure of Financing

In light of this market disruption, the financing banks stood to lose substantially on each of these transactions if they completed. So, it was not surprising that evidence began to emerge in the Fall that these banks were actively agitating to terminate these transactions. In the Fall of 2007, lenders in the HD Supply and Reddy Ice private equity acquisitions had interpreted their debt commitment letters to attempt to escape financing renegotiated transactions.¹⁴³ In each of these deals, the banks had asserted that the renegotiation of the terms of the transaction constituted an “adverse change” under their debt financing letter entitling it to terminate that letter.¹⁴⁴ The Reddy Ice transaction ultimately was terminated through payment of the reverse termination fee by the private equity firm while the banks’ position forced a renegotiation of the HD Supply transaction.¹⁴⁵ In addition, in the Acxiom transaction two of the financing banks had agreed to reimburse the private equity firms for part of the reverse termination fee. Presumably they did this so as to incentivize the private equity firms to terminate the transaction.¹⁴⁶ In all these instances, these disputes and arrangements remained private and did not result in any litigation or public dispute.¹⁴⁷ However, the stress in the banking/private equity relationship broke to the surface in the litigation surrounding the Clear Channel TV station transaction. In that transaction, Wachovia sued and asserted that a renegotiation of the purchase price constituted an “adverse change” under its debt financing letter.¹⁴⁸ The litigation was settled by Wachovia before any decision could be rendered, but in the settlement Wachovia achieved a reduction of its financing commitment.¹⁴⁹

The most significant failure in the private equity/lender relationship occurred in the litigation over the \$26 billion purchase of Clear Channel by

¹⁴³ See Henny Sender, et al., *Home Depot Hit As Credit Crunch Squeezes Deals*, THE WALL ST. J., Aug. 27 2007; David Carey & Vipal Monga, *Morgan Stanley hints at pull from Reddy*, THEDEAL.COM, Sept. 13, 2007.

¹⁴⁴ *Id.*

¹⁴⁵ See Reddy Ice Current Report on Form 8-K, dated Feb 1, 2007, available at http://www.sec.gov/Archives/edgar/data/1268984/000110465908006289/a08-4392_18k.htm; Sender, *supra* note 143.

¹⁴⁶ See Andrew Ross Sorkin, *Acxiom Shows Breaking Up Is Costly*, THE N.Y. TIMES, Oct. 10, 2007.

¹⁴⁷ See Vipal Monga, *When friends fall out*, THEDEAL NEWSWEEKLY, Sept. 21, 2007.

¹⁴⁸ See Andrew Ross Sorkin & Michael J. de la Merced, *Bank Sues Acquirer of Clear Channel Unit, Jeopardizing Deal*, THE N.Y. TIMES, Feb. 25, 2008, C2.

¹⁴⁹ See Andrew Ross Sorkin & Michael J. de la Merced, *Lawsuit Is Settled Over Sale Of Clear Channel's TV Unit*, THE N.Y. TIMES, March 15, 2008, at C3.

Bain Capital and Thomas H. Lee. On March 26, 2008, Bain and Thomas H. Lee sued their financing banks in New York Supreme Court.¹⁵⁰ In their complaint, the private equity firms alleged that the banks had breached their commitment letters by demanding unreasonable terms that were onerous and unusual in the final negotiated credit documentation in an attempt to terminate their obligations under the letter, something the banks were incentivized to do since they would incur an estimated \$2.6 billion collective loss if they were forced to fund.¹⁵¹ Market conditions had changed that substantially from the time the banks had initially agreed the financing terms in their debt commitment letter.

The private equity firms asserted that this language violated the requirement in the debt commitment letter that the final negotiated credit agreements “contain the terms and conditions set forth in this Commitment Letter and shall be customary for affiliates of the Sponsors.”¹⁵² This “sponsor precedent” clause was considered quite friendly to the private equity firms since it narrowed the scope of precedent to be referenced to that in which the sponsor, another name for the private equity firm, had previously agreed to and so ensured that the private equity firms would obtain a favorable deal.

The banks countered that the 71 page debt commitment letter was unenforceable because it contained too many open terms – only with final documentation would the contract be sufficiently complete to be enforceable.¹⁵³ In addition, the banks argued that a specific performance remedy was unavailable to the private equity firms – they could only collect money damages.¹⁵⁴ In this case the private equity firms would be subject to a Catch-22 since the banks also argued that money damages would be unavailable under the terms of the debt commitment letter which they asserted barred monetary damages and the acquisition agreement which in any event limited the private equity firms’ monetary damages to \$500 million.¹⁵⁵ Finally, the banks argued that the sponsor precedent language cited by the private equity firms was essentially meaningless since, due to

¹⁵⁰ The banks were Citigroup, Deutsche Bank AG, Credit Suisse Group, Morgan Stanley, Royal Bank of Scotland Group and Wachovia Corp. See Complaint in *BT Triple Crown Merger Co., Inc., et al. v. Citigroup Global Markets Inc.*, dated Mar 25, 2008, available at http://graphics8.nytimes.com/images/blogs/dealbook/CCU_NY_lawsuit.pdf.

¹⁵¹ *Id.* at ¶¶ 6-8.

¹⁵² *Id.* at ¶ 16.

¹⁵³ See Memorandum of Law in Support of Defendants’ Motion for Summary Judgment, *BT Triple Crown Merger Co., Inc., et al. v. Citigroup Global Markets Inc.*, at 21-25, dated Apr 10, 2008, available at <http://graphics8.nytimes.com/images/blogs/dealbook/CCUdismissmotion.pdf>

¹⁵⁴ *Id.* at 16-21.

¹⁵⁵ *Id.* at 10-16.

the state of the market, no transaction was customary or similar.¹⁵⁶

This dispute settled with a renegotiated price, an increase in the equity commitment by the private equity firms and the interest rate they were to pay on their bank debt and a decrease in the amount of debt financing provided by the banks.¹⁵⁷ In this tissue of legal points was a fundamental truth – the banks in the Clear Channel case argued that the debt commitment letters were an option that they could refuse to fund on with at most a penalty equivalent to private equity's reverse termination fee.¹⁵⁸ The wave of litigation and dispute which had enveloped private equity now had placed into doubt the entirety of the private equity structure: the reputational forces pushing private equity firms to complete acquisitions, the mechanics of enforcing the specific performance form of the private equity structure, and the enforceability of debt commitment letters.

III. NEGOTIATING THE STRUCTURE OF PRIVATE EQUITY

The collapse of the private equity structure brought recrimination and criticism among and upon the participants in private equity buy-outs – financial institutions, private equity firms, acquirees and lawyers in particular. The criticisms were broad-based and were directed at the following alleged lapses:¹⁵⁹

Failure of Certainty. Acquirees were condemned for agreeing to optional takeover structures. Critics claimed that acquiree boards were wrong to agree to reverse termination fee provisions thereby forgoing deal completion certainty equivalent to that in strategic transactions.

Failure of MAC Clauses. In the first wave of post-August 2007 private equity terminations, MAC clauses functioned in a manner different than acquirees and their attorneys likely intended. The existence of these clauses permitted acquirers to invoke them to provide reputational cover for otherwise exercising reverse termination fee provisions. Moreover, the repeated invocation of MACs and the success of acquirers in terminating their transactions lessened reputational constraints allowing for the exercise of the reverse termination fee provision without an accompanying MAC claim. The net effect was to deprive acquirees of the full reputational

¹⁵⁶ See Motion on Expert Testimony, BT Triple Crown Merger Co., Inc., et al. v. Citigroup Global Markets Inc., at [●], dated [●].

¹⁵⁷ See Clear Channel Current Report on Form 8-K, dated May 15, 2008, available at <http://www.sec.gov/Archives/edgar/data/739708/000095013408009540/d56929e8vk.htm>.

¹⁵⁸ See Steven M. Davidoff, *A Clear Channel Scorecard*, N.Y. TIMES DEALBOOK, Apr 16, 2008, available at <http://dealbook.blogs.nytimes.com/2008/04/16/clear-channel-scorecard/#more-22511>.

¹⁵⁹ See Steven H. Goldberg, *Deals gone bad*, THEDEAL.COM, Aug. 19, 2008.

closing force they had likely counted upon when negotiating their agreements.¹⁶⁰

Failure of Specific Performance. The attorneys negotiating the specific performance mechanism of the reverse termination fee structure did so in the belief that it was an enhanced form of the reverse termination fee structure.¹⁶¹ But in negotiating this structure, these attorneys failed to fully account for the problems with enforcing this arrangement through shell subsidiaries, the lack of judicial precedent governing enforcement of this mechanism, the difficulty of forcing shell subsidiaries to enforce debt and equity commitment letters with differing choice of law and forum clauses and the uncertainty as to whether specific performance could even be awarded under Delaware law.¹⁶²

Failure of “Best Efforts”. A similar failure appeared to occur with respect to “best efforts” clauses negotiated in the pre-August 2007 private equity structure. Attorneys often negotiated that the shell subsidiary would use its reasonable best efforts to complete this transaction, particularly to obtain regulatory approvals or replacement financing.¹⁶³ But the meaning of reasonable best efforts is still uncertain under Delaware law.¹⁶⁴ Moreover, the private equity parties subject to this clause were shell subsidiaries with little or no assets.¹⁶⁵ The implementation of this clause was thus dependent upon the voluntary cooperation of the private equity funds themselves. If regulators or the private equity firm refused to cooperate, it would result in substantial difficulties and legal uncertainties in forcing the private equity shells to close. This is exactly what happened in the ADS litigation.¹⁶⁶

Failure of Drafting. Finally, the private equity agreements themselves contained ambiguities and conflicting provisions. In some cases like the URI-Cerberus litigation it appeared that these defects were attorney drafting mistakes.

Shareholders and commentators attributed these lapses to a number of

¹⁶⁰ Moreover, the parties often negotiated two-tiered reverse termination fees, a higher fee if the acquirer simply breached its obligations but a lower one if financing was unavailable. In at least one significant post-August transaction, the failed buy-out of Acxiom, the private equity acquirer invoked a MAC provisions and the similar prospect of lenders doing the same to force a settlement at the lower reverse termination fee. See Interview, *supra* note 88 .

¹⁶¹ See *supra* notes 72-74 and accompanying text. See also David Leinwand and Victor Goldfeld, *Stresses on the New LBO Deal Architecture: United Rentals Goes to Court* (Cleary Gottlieb Newsletter Jan. 2008).

¹⁶² See also Kevin Miller, *The ConEd Decision - One Year Later: Significant Implications for Public Company Mergers Appear Largely Ignored*, 10 THE M&A LAWYER 9, Oct. 2006.

¹⁶³ See *supra* notes 119-120 and accompanying text.

¹⁶⁴ See *supra* notes 126-128 and accompanying text.

¹⁶⁵ See *supra* notes 122-124 and accompanying text.

¹⁶⁶ See *supra* Part III.C.

factors, including lax oversight, a failure to recognize and appreciate the risks of the private equity structure, and management's oft conflicted role in these buy-outs which led them to overlook the problems with this structure.¹⁶⁷ The lawyers for these acquirees were also criticized for negotiating these optional structures and accused of failing to properly advise acquirees of the inherent risk.¹⁶⁸ But this criticism belies a much more nuanced picture in the negotiation of these structures. Upon examination, acquirees and their lawyers did appear to make a number of miscalculations but their failures were premised upon other fault lines.

A. Optionality and the Private Equity Structure

a. Structuring the reverse termination fee

Criticism of the private equity structure was principally directed at the optionality and resulting uncertainty it created. In its purest form, the reverse termination fee structure created an option.¹⁶⁹ The private equity firm had the discretion to exercise this option, and if the firm did so, it could terminate the transaction and pay the reverse termination fee. A private equity acquirer could thus assess the benefits of the transaction before completion and decide whether it was more economical to complete the transaction or otherwise pay the reverse termination fee and terminate the acquisition agreement.

This option was not calculated according to any option pricing method. Nor did it appear to be calculated by reference to the damage incurred by a acquiree in the event it was exercised by the private equity firm in order to terminate the transaction. The amount ultimately paid also did not deter acquirers from exercising it in many instances. Rather, the amount of the reverse termination fee was set normatively by reference to the termination fee typically paid by acquirees, approximately three percent of the transaction value.¹⁷⁰ Setting the fee at 3% for acquirer and acquiree made for a symmetrical penalty.¹⁷¹

¹⁶⁷ See Davidoff, *supra* note 9.

¹⁶⁸ See, e.g., Nowicki, *supra* note 91, at 3.

¹⁶⁹ See Davidoff, *supra* note 75.

¹⁷⁰ From 2005-2007, the average size of a reverse termination fee was [•] percent of the transaction value. MergerMetrics Database. See PETER V. LETSOU, CASES AND MATERIALS ON CORPORATE MERGERS AND ACQUISITIONS 619 (2006) (“[Break-up] fees are almost always set at approximately 3 percent of the transaction value.”). It largely remained at this amount from transaction to transaction without variance. In my dataset of [174] private equity transactions, I calculated that during the period from 2004-2007 the reverse termination fee ranged from []-[]% of the transaction value with a mean percentage value of [] and a median of []. Author calculations based on data from the Merger Metrics Database.

¹⁷¹ When asked how the reverse termination was set, attorneys confirmed that setting the reverse termination fee at 3% was an adoption of the norm for acquiree termination fees. Interview D.

The fact that each of these penalties existed for different reasons and worked differently shows the strength of the norm in operation. The reverse termination fee provided a liquidated damages remedy equivalent to the termination fee paid by acquirees.¹⁷² This latter fee was capped by Delaware case-law and was designed to deter competing bids and compensate bidders for the costs associated with making a trumped offer.¹⁷³ But the same principles did not apply in the reverse termination fee context. The fee in a number of prominent instances did not deter exercise of the option and in hindsight the amount appeared to under-compensate acquirees for the losses incurred by the acquiree company and its shareholders.¹⁷⁴ Evidence of this came from the post-termination share trading prices of acquirees against whom these provisions were invoked. In the months after the exercise of this provision, the share prices of these companies traded significantly below the pre-offer price.¹⁷⁵

Despite the seeming miscalculation of the reverse termination fee, market participants interviewed for this study almost all asserted that the optionality of the reverse termination fee structure was well known prior to August 2007 among lawyers and transaction participants.¹⁷⁶ The testimony in the United Rentals/Cerberus dispute supports these assertions. In that dispute, the parties disagreed over the language of their termination – whether it was a specific performance reverse termination fee structure or a pure reverse termination fee structure. The description in the judicial opinion of the parties bargaining, though, reveals that they did appreciate the choice:

Throughout the course of negotiation of the Acquisition agreement, [United Rentals (“URI”)] contends that it communicated to [Cerberus Parent Shell Subsidiary’s (“RAM”)] principal attorney contract negotiator, Peter Ehrenberg of Lowenstein Sandler PC, that URI wanted to restrict RAM’s ability to breach the Acquisition agreement and unilaterally refuse to close the transaction. URI further maintains that URI’s counsel, Eric Swedenburg of Simpson Thacher & Bartlett LP, made clear to Ehrenberg that it was very important to URI that there be

¹⁷² See *Brazen v. Bell Atlantic Co.*, 695 A.2d 43 (1997) (applying a liquidated damages analysis to a termination fee in a strategic merger to determine the validity of a termination fee provision).

¹⁷³ For a discussion of termination fees in the context of change of control transaction. See generally *In re Toys “R” Us, Inc. Shareholder Litigation*, 877 A.2d 975 (Del. Ch. 2005).

¹⁷⁴ See Vopal Monga, *Turning the tide*, THE DEAL, Aug. 29, 2008 (“James Woolery, a partner in Cravath, Swaine & Moore LLP’s M&A practice [asserts] that reverse termination fees, typically set at around 3%, often understate[d] the risk of deal failure.”)

¹⁷⁵ See, e.g., Nowicki, *supra* note 91, at 7.

¹⁷⁶ Interviews with D, E.

“deal certainty” so that RAM could not simply refuse to close if debt financing was available. On the other side of the negotiation table, the RAM entities argue that Ehrenberg consistently communicated that Cerberus had a \$100 million walkway right and that URI knowingly relinquished its right to specific performance under the Acquisition agreement.¹⁷⁷

The reverse termination fee structure also provided more closing certainty than the structure it supplanted. In the pre-2005 structure, the structure was wholly optional – the acquiree entered into an agreement with thinly capitalized shell subsidiaries and the agreement itself contained a financing condition.¹⁷⁸ If the subsidiaries refused to perform or otherwise financing failed the acquiree was left with no compensation or recourse to the private equity firms except through a veil piercing or other creative litigation argument.¹⁷⁹ The reverse termination fee structure reduced optionality in the structure by imposing a penalty upon private equity firms for refusing to complete transactions, and in its specific performance form purported to ensure that the acquisition would occur if all of the conditions to completion were fulfilled and financing was available.

b. Explaining the Reverse Termination Fee

Attorneys at the major private equity law firms on some level thus appeared to be aware of the optionality embedded in these structures. They also appeared to negotiate among these structures to select more or less optional structures. However, the question remains why acquirees advised by their lawyers assumed this transaction risk? Furthermore, why did lawyers set the size of the reverse termination fee through an inapposite norm rather than varying it depending upon the circumstances of the transaction? Within these questions is another one concerning whether acquirees and their attorneys fully comprehended or were advised of the risks inherent in these structures, and if so why they still agreed to these contracts.

Attorneys interviewed for this Article generally stated that they were aware of the optionality inherent in this structure, and asserted that they had

¹⁷⁷ United Rentals, Inc. v. RAM Holdings, Inc., et al., 937 A.2d 810, 818-819 (Del. Ch. 2007).

¹⁷⁸ See Sorkin & Swedenburg, *supra* note 50, at 3.

¹⁷⁹ The arguments in the ADS litigation – that a parent had some sort of responsibility to a subsidiary represent this type of creative lawyering. Unfortunately, for acquirees though, a veil piercing argument was often unavailable since the private equity guarantees typically contained strong no-recourse language. See, e.g., Steven M. Davidoff, *The Private Equity Lawsuit of the Year*, N.Y. TIMES DEALBOOK, Feb. 27, 2007, available at <http://dealbook.blogs.nytimes.com/2008/02/27/the-private-equity-lawsuit-of-the-year/> (discussing the language of the no recourse guarantee in the acquisition of 56 television stations by Providence Equity from Clear Channel).

informed their boards of this optionality.¹⁸⁰ In both instances though participants repeatedly asserted that the negotiated contractual terms were not the only basis for agreeing to this transaction structure. Rather attorneys for acquirees in these scenarios relied upon the interaction of contractual terms and extra-contractual forces and understandings to complete the private equity contract. The parties bargained to create incentives within the contract to force a closing primarily the reverse termination fee. But attorneys for acquirees also relied upon reputational norms and conventions as well as other external forces to fill perceived “gaps” in the contract.¹⁸¹ Again, the judicial description of the bargaining between URI and Cerberus provide support for these assertions:

Swedenburg explained that URI would require a reverse break-up fee of sufficient size to ensure that it would be “scary” and “painful” for the RAM Entities to walk away from the transaction. Swedenburg noted that URI was not content merely to rely upon the reputational fallout that would ensue if the RAM entities and their affiliates failed to close.¹⁸²

The private equity contract created a monetary penalty that was deemed to be completed in part by the reputational norm pressuring the private equity firm to complete the transaction.¹⁸³ In this multiplayer game, private equity was a repeat player. As such, it was assumed that the reputational incentive to close would keep them from exercising the reverse termination fee option and being perceived as reneging on their deals.¹⁸⁴ The penalty for failure to follow this norm would be a higher price paid in future transactions to compensate acquirees for this failure and increased risk as well as any other public approbation for this action. This penalty together with the required reverse termination fee was presumed to be adequate to prevent exercise of this option.

Moreover, the acquisition contract and its negotiation served as a bonding mechanism enhancing these norms and constraints. The negotiation process not only established the legal parameters of their agreement but in the discourse of the parties also established a relationship to sustain their

¹⁸⁰ Interviews with F, G.

¹⁸¹ See David Chamy, *Nonlegal Sanctions in Commercial Relationships*, 104 HARV. L. REV. 373, 392-94 (1990) (discussing types of nonlegal sanctions as penalties in commercial transactions)

¹⁸² *United Rentals*, 937 A.2d at 825.

¹⁸³ See Ronald H. Coase, *The Nature of The Firm: Influence*, 4 J. L. ECON. & ORG. 33, 44 (1988) (arguing that opportunistic behavior is typically checked by reputational constraints). *But see* Oliver E. Williamson, *Transaction-Cost Economics: The Governance of Contractual Relations*, 22 J.L. & ECON. 233, 241 (1979).

¹⁸⁴ Cf. Rubén Kraiem, *Leaving Money on the Table: Contract Practice in a Low-Trust Environment*, 42 COLUM. J. TRANSNAT'L L. 715, 736 n.31 (2004).

transaction. Here, the conversations outside the four corners of the contract solidified the acquiree's willingness to rely on these extra-contractual factors to complete its acquisition contract. Again, the description in the URI judicial opinion of the parties negotiation provides support for this observation:

On July 21, 2007, in a conversation between Mayer, Kochman, and McNeal, Mayer indicated that he thought RAM was purchasing an "option," Kochman strongly disagreed with the contention. Kochman testified about that conversation:

A. He said, you know, "Gee, that's a lot of money. You know, I view this as an option. And my LPs would be very unhappy if I, you know, burnt that 100 million plus dollars." And I was taken aback by that.

Q. And what did you say to him?

A. I said, "You know, that's crazy. That's a nonstarter. This is not an option. That's something I would never take back to the board." And I laid into him fairly good and said that this is a board that has concerns about your ability to consummate transactions. They see what's going on with Chrysler. They don't view you in the same breaths as KKR or Blackstone. And, you know, it's a complete nonstarter.

Q. Did he respond to that?

A. He backed away. He said, "Time out. You know, I'm 100 percent committed to this transaction. I'm going to take you—I'm going to tell you right now that the debt financing and the commitment letters we have in hand are designed exactly for difficult markets. We'll get this deal done. I'm going to take you under the tent."¹⁸⁵

A third force, the economic incentives of private equity firms, was also cited by attorneys as completing the private equity structure and justifying

¹⁸⁵ United Rentals, 937 A.2d at 826-27. Another example is from a Wall Street Journal article reporting on the agreement negotiations between Huntsman and Hexion. According to the article, Jon Huntsman, the Chairman of Huntsman's board of directors "states he was suspicious of Apollo's willingness to close the deal at that price. 'It was important to me that I have Black and Harris shake hands with them at our Deer Valley home,' he [said]. 'I wanted them to look [the senators] in the eye and tell them it was a done deal.' Mr. Huntsman says that Mr. Black assured the group he had a '100% commitment to close the deal,' and that Mr. Harris assured him repeatedly the deal was 'solid.'" See Susan Pullman & Peter Lattman, *As Buyout Bust Turns Bitter, A Major Deal Lands in Court*, THE WALL ST. J., Sep. 9, 2008.

its contractual optionality.¹⁸⁶ Private equity is in the business of acquiring companies. When they enter into an agreement to do so, this force and the momentum it creates pushes the private equity firm to complete the acquisition. In other words, private equity firms, initially enter into the transaction because of a desire to acquire the company. The transactional costs incurred to first enter into this agreement and the commitment it represents also pressure private equity firms to complete their transactions.¹⁸⁷

The particular reputational and economic forces upon private equity provide a strong explanation for why a different, more certain structure has historically been utilized for strategic transactions – acquisitions made by a functioning company rather than a private equity firm. Strategic transactions lack the optional nature of private equity acquisitions. In strategic transactions the structural norm is to eschew financing conditions and reverse termination fee structures.¹⁸⁸ Instead acquiree companies obligate the acquirer to specifically perform the acquisition in case of a breach of the acquisition agreement.¹⁸⁹ Moreover, unlike the private equity context, this agreement is secured by the assets of the acquirer.¹⁹⁰

The traditional reason offered for this dichotomy in structure is a financing rationale. In a strategic transaction an acquirer has assets to secure its obligations and is not dependent upon the vicissitudes of the financing market to complete its transaction. But, many strategic acquirers employ substantial leverage to effect acquisitions while private equity funds do have assets – the contractual agreements of their limited partners to fund. Accordingly, a stronger explanation is that a strategic acquirer is not in the business that private equity firms are – acquiring companies. If a strategic acquirer reneges on its acquisition agreement the reputational loss is likely to be less since it is not consistently in the acquisition market, and stronger contractual protections are justified.¹⁹¹

Thus, acquiree attorneys relied upon these forces to negotiate the

¹⁸⁶ Interviews with K, L.

¹⁸⁷ Cf. John C. Coates IV & Guhan Subramanian, *A Buy-Side Model of M&A Lockups: Theory and Evidence*, 53 STAN. L. REV. 307 (2000) (positing that bidders may remain committed to pre-agreed acquisitions due to transactional switching costs since “[o]nce a given strategy has been devised and communicated, remaining committed to that strategy will be ‘free,’ and optimal, as long as the net gain from switching to a new strategy is less than the cost of communicating the new strategy.”)

¹⁸⁸ See Steven M. Davidoff, *Wrigley and the Future of M&A*, N.Y. TIMES DEALBOOK, May 1, 2008, available at <http://dealbook.blogs.nytimes.com/2008/05/01/wrigley-and-the-future-of-ma/>.

¹⁸⁹ See Yair Jason Listokin, *The Empirical Case for Specific Performance: Evidence from the Tyson-IBP Litigation* (Mar 1, 2005), available at SSRN: <http://ssrn.com/abstract=679874> (last visited Feb 10, 2008).

¹⁹⁰ See WILLIAM J. CARNEY, *MERGERS AND ACQUISITIONS: CASES AND MATERIALS* (2nd Ed. 2007).

¹⁹¹ In the wake of the credit crunch, reverse termination fee clauses have crept into strategic deals with financing risk. It remains to be seen whether these features will persist when the markets eventually stabilize.

structure of private equity. Here, attorneys for acquirees asserted that this structure was the best deal available, that private equity firms were unwilling to agree to more certain, different terms.¹⁹² Boards advised by their attorneys made the conscious decision to accept these transaction premiums in exchange for accepting this deal uncertainty.¹⁹³ Moreover, these attorneys also highlighted competitive bidding situations wherein private equity firms did indeed agree to strategic type completion structures.¹⁹⁴ They cited the existence of these provisions in this context to justify their agreement as merely a reflection of the competitive environment, resulting bargaining strength of the parties and consequent agreement achieved.

The notion that parties sometimes leave contractual terms incomplete or vague in order to reach a contract and otherwise avoid a dispute is well discussed in the contracts literature.¹⁹⁵ In that scenario, parties prefer to leave any further disputes to the courts, and any incentives to ex post facto negotiation in order to avoid such litigation, rather than fail to reach an agreement altogether.¹⁹⁶ In the private equity model, it appears that the arguments of attorneys that these contractual terms were the best available are a species of this theory. Acquirees advised by their attorneys concluded that the contractual terms themselves were enhanced by the normative and economic incentives and constraints existent. In such circumstance they were willing to agree to a reverse termination fee structure and negotiate away contractual protections due to reliance on these factors. The bargain struck in contract was thus perceived by acquirees as an acceptable one due to reliance upon extrinsic forces and the consequent perceived unavailability of a better bargain.

¹⁹² See Monga, *supra* note 174 (“Instead, at the time the deal was struck, the directors saw the fee as a basic price of doing business, given that none of the potential acquirers of the company would sign without the conditional put. In addition, the board felt the chances the transaction would fall apart were slim.”)

¹⁹³ Interview with N.

¹⁹⁴ See, e.g., Davidoff & Baiardi, *supra* note 78 (detailing the competitive bidding by Lone Star Funds for Accredited Home Lenders and the specific performance contract which arose). Interestingly, at no point did anyone state that this certainty or uncertainty affected deal premiums. There is evidence that post August 2007 there has been some attempts to relate these two at least in public descriptions of the transaction negotiation. See, e.g., Schedule 14D-9 filed by Golden Telecom, at 23-25, dated Jan. 18, 2008, available at <http://www.sec.gov/Archives/edgar/data/1089874/000119312508008895/dsc14d9.htm>.

¹⁹⁵ See Bernheim & Whinston, *supra* note 11. It is also a publicly commented upon phenomenon. See Ben Hallman, *Our Dealmakers of the Year Section Spotlights Achievement in Corporate Work but The Lawyering in the United Rentals Buyout, on the Other Hand, Didn't Lead to Glory – Just to Court*, 30 AM. LAWYER 4, Apr. 2008 (“Lawyers familiar with the deal say they believe the United Rentals case offers a glimpse into a little-noticed but common practice: Deal lawyers often agree to contracts with ambiguous language for the sake of compromise.”). This practice is one similar to parties otherwise agreeing to leave a contractual term gap in a contract. See Lisa D. Bernstein, *Social Norms and Default Rules Analysis*, 3 S. CAL. INTERDISC. L. J. 59, 66 n. 34 (1993-94); George Geis, *An Embedded Options Theory of Indefinite Contracts*, 90 MINN. L. REV. 1664 (2006).

¹⁹⁶ Additionally, parties calculate the likelihood of those contingencies is sufficiently remote that it's not worth the added negotiating cost, or the increased risk of failure to complete a deal.

B. Other Facets of the Private Equity Structure

In this light, acquirers' and their agent attorneys' agreement to a reverse termination fee structure was likely justified to themselves. It was seen as the only available bargain agreeable to private equity firms and otherwise completed by externalized forces. Even so, attorneys for acquirers did not then fix the other known embedded flaws in the private equity structure. Instead, lawyers again appeared to rely on norms and external understandings and constraints to complete the structure blessing the final deal as the best available bargain.

In the negotiation of the reverse termination fee the contract served as a bonding mechanism among the parties and its negotiation as a vehicle to create a relationship and to signal its strength.¹⁹⁷ This practice carried through to other parts of the private equity contract negotiation. So for example, in selecting the efforts to be required of the shell subsidiaries to obtain regulatory approvals or alternative financing, lawyers typically negotiated among "reasonable best efforts" and "best efforts" with the latter considered a stronger contractual obligation.¹⁹⁸ In reality the choice of "best efforts" over "reasonable best efforts" did not create a significantly incremental requirement on the acquirer because in either case the acquirer was a shell subsidiary with limited assets. The acquirer's efforts were therefore *per se* limited. Moreover, lawyers often had a mistaken understanding of what best efforts or even reasonable best efforts meant and the difference between the two.¹⁹⁹ This misunderstanding was often enhanced by the lack of case-law on the meaning of "reasonable best efforts".²⁰⁰

Despite the confusion about the meaning of "best efforts" and its variants, the parties could signal their commitment to the transaction by selecting the higher or lower standard. It did not matter for contractual purposes, but it permitted the parties to gauge their commitment and allowed for future bargaining after the execution of the contract over the meaning of the parties' commitment. Moreover, the negotiation over the selection among "efforts" would orally establish the level of conduct

¹⁹⁷ See Mark C. Suchman, *The Contract as Social Artifact*, 37 LAW & SOC'Y REV. 91, 111 (2003). ("contract rituals provide symbolic reassurance that the parties are entering into a predictable, controllable, and mutual relationship within a social order composed of voluntary arm's-length exchanges between equally endowed strangers").

¹⁹⁸ See Kenneth A. Adams, *Understanding "Best Efforts" And Its Variants (Including Drafting Recommendations)*, THE PRACTICAL LAWYER, 12-13, Aug 2004 (asserting that lawyers' conventional understandings of best efforts and its variants is at odds with the case law)

¹⁹⁹ *Id.*

²⁰⁰ See *supra* note 126 and accompanying text.

expected of the parties under the agreement prior to the contract's execution. I believe this is why the lawyers in the ADS transaction inexplicably negotiated a contract which required the Blackstone shell subsidiary to use reasonable efforts to complete the transaction when the real party whose action would be required, the Blackstone fund itself, was not so obligated. ADS and its lawyers through discussion and negotiation of the regulatory efforts covenant likely satisfied themselves over what Blackstone was and was not willing to do. The need to document these actions in the contract was thus seen as an appropriate risk to forgo. Instead, the dialogue established that Blackstone could be trusted to engage in the necessary conduct to complete the transaction. Unfortunately for ADS, the assumption turned out wrong.²⁰¹

Similarly, the choice of a specific performance model over a pure reverse termination fee was a means for the parties to signal higher commitment to the transaction. This was true even though there were doubts about the effectiveness of the specific performance form. In other words, lawyers had their extra-legal interpretation of the contract which served to create an understanding of the intentions of the parties at times at odds with the contract itself. The negotiation in the URI/Cerberus acquisition amply illustrates this. Eric Swedenburg, attorney at Simpson Thacher for URI, started the negotiations by insisting that this would not be an optional deal, but rather one modeled on the specific performance form.²⁰² The failure of URI to obtain this form of deal structure was likely a signal of URI's commitment, one which may have been ignored by URI due to the outside conversations between Cerberus and URI in which Cerberus committed itself to completing the transaction.

This extra-legal discourse, the signals it sent and the understandings it led to also explains the existence of drafting error, contract gaps and the agreement of acquirers and acquirees to flawed and potentially flawed contract terms. Attorneys for acquirees relied on extra-legal contractual understandings and forces to ensure that the contract completed. In this circumstance, they did not push to flush out all of the errors in the contract or otherwise to make a more complete contract. Instead they relied upon these forces to forgo fixing the contract.²⁰³ In other words, the attorneys felt

²⁰¹ Another example came in the Penn National Gaming transaction. There the lawyers did not contractually bind the acquiring funds to cooperate with needed regulatory approvals despite the clear knowledge that such cooperation would be required.

²⁰² See *United Rentals, Inc. v. RAM Holdings, Inc., et al.*, 937 A.2d 810, [●] (Del. Ch. 2007).

²⁰³ The time constraints of these transactions also often permitted attorneys to justify these "mistakes". See, e.g., *The Partner Survey: The View From the Top*, AM. LAW., Jun 1999, at 79, 82 (surveying partners at the top 100 grossing law firms and finding that 52% who responded and worked greater than a sixty hour work week "worked so fast they made mistakes").

they could safely ignore these failings since other extra-legal factors provided them confidence that they would not matter.²⁰⁴ Moreover, as the United Rentals case showed, the extra-contractual dialogue between attorneys and parties reinforced their own interpretation of these clauses even in the case of erroneous or ambiguous drafting -- interpretations they likely felt that their own created relationships would work to enforce.²⁰⁵ The contract would sometimes be ignored for the private understandings of the parties.

It is here where the importance of the contract comes into play and explains why parties did not simply negotiate a letter of intent or a less formal agreement. First, the contract provided a blueprint for the parties to follow.²⁰⁶ Second, the contract negotiation itself created a mechanism through which the parties could bond and gain an understanding of each others' commitment and intentions. Third, the contract created its own mechanics pushing towards a closing by establishing a formal relationship.²⁰⁷ But the contract terms were also negotiated to be enforced and altered depending upon the relational bonding of the parties. Even in the end-game the parties attempted to enforce the private understandings of the parties and reputational norms.²⁰⁸ This was ably illustrated in both the ADS and Huntsman litigations.

Finally, the flaws and uncertainty, deliberate and otherwise, in the private equity structure provided a means for further negotiation when the relationship did indeed begin to collapse. They ensured that the parties would likely continue their dialogue before and after any litigation was

²⁰⁴ The lawyer in this instance was the primary translator of this granular language into broader concepts for the client to approve and understand since they were the primary negotiator for their principal. But he or she in certain circumstances also appeared to be acting autonomously making granular choices with little oversight or approval by the client itself. *See also* Coates, IV, *supra* note 19, at 1303 (2001) (examining the adoption of structural defenses by companies at the IPO stage and finding that "Corporate lawyers, at least at the IPO stage, appear to be working relatively free of market, ethical, or other constraints, and many appear to be making choices, and mistakes, without determining whether such choices are in the long-term interests of their clients (that is, pre-IPO owner-managers)."); Donald C. Langevoort & Robert K. Rasmussen, *Skewing the Results: The Role of Lawyers in Transmitting Legal Rules*, 5 S. CAL. INTERDISC. L.J. 375 (1997) (positing a theoretical construct that lawyers may tend to overstate legal advice). *See generally* George M. Cohen, *When Law and Economics Met Professional Responsibility*, 67 Fordham L. Rev. 273 (1998).

²⁰⁵ As Professor Claire Hill has observed, the institutional structure of law firms often produces lawyers who are incentivized to produce "good enough" drafting safe in the assumption that the specter of litigation and other transaction costs will prevent any errors from discovery or exploitation. *See* Hill, *supra* note 19, at [*].

²⁰⁶ *See* Suchman, *supra* note 199, at 110. *Cite also* Bernstein.

²⁰⁷ *See* Claire A. Hill, *A Comment on Language and Norms in Complex Business Contracting*, 77 CHI. KENT LAW REV. 29, 47-48 (2001) (noting that despite common "technical" failures to meet closing conditions in contracts, a party entitled to assert a termination right in such circumstance will instead close often after a renegotiation).

²⁰⁸ *See also* Andrew Willis, *BCE deal on track for August closing: Teachers in sound negotiating position, battered banks honour commitment to buyout*, GLOBE & MAIL, Jun 23, 2008 (reporting on negotiations over the BCE buy-out and reporting that "[f]or all the noise, it's worth noting that Citigroup and Deutsche Bank [the lead lenders] have never failed to honour their commitment to a buyout," said a source working the lenders.)

commenced.²⁰⁹ This would force them to work towards completion of the transaction and resolution of their disputes. Moreover, the unique nature of litigation in Delaware – which provided a forum for speedy and public dispute resolution – worked to reinforce the reputational norms towards resolution of disputes and air the parties’ private understanding of the private equity structure and contract.²¹⁰

In sum, the reverse termination fee was not the only result of extra-legal considerations. Attorneys negotiated in reliance upon extra-legal norms, signals and understandings to complete the private equity structure and establish a relationship to engender completion of the transaction even upon litigation. An example again comes from the failed United Rentals transaction. In that transaction, Simpson Thacher, the attorneys for the acquiree likely negotiated an ambiguous document, engaged in relational bonding in negotiating the contract and pushed for a higher reverse termination fee to offset the failure to negotiate a more certain closing structure with the four corners of the contract itself.²¹¹ The contract was not just negotiated for its bonding, signaling, and terminology – but as a back-stop in the final end-game of litigation.²¹² In such a circumstance, the created relationship and understandings could engender further bargaining before litigation and a platform to enforce reputational norms and any other understanding during such litigation.

IV. THE PATH DEPENDENCY OF THE PRIVATE EQUITY STRUCTURE

The preceding Part discussed how acquirees and their attorneys faced with the structure of private equity negotiated and justified it. Nonetheless, the question remains how the private equity structure came to be and why these forces worked so strongly to prevent change. The private equity industry is a highly sophisticated one with the capability to renegotiate the structure at any time. The primary impediments to fixing these problems – many of which were known -- were two-fold: time and obtaining the agreement of the private equity parties. The transaction costs to fix these flaws were low, and lawyers for acquiree companies were incentivized to bargain for certainty through success fees in addition to their regular fees. For example, counsel representing United Rentals, Simpson Thacher, was

²⁰⁹ See Hill, *supra* note 11, at [●].

²¹⁰ See *supra* notes and accompanying text.

²¹¹ See *supra* at Part III.A.2.

²¹² In fact, this is what likely led Cerberus to make an offer to settle the dispute on the eve of trial, an offer which United Rentals rejected. See *Cerberus Offers to Redo United Rentals Deal*, THE N.Y. TIMES, Nov 16, 2007.

to be paid a \$5 million bonus if the transaction completed.²¹³ This was on top of their multi-million dollar legal fee.²¹⁴ So, the question remains why attorneys were so reliant on these extra-legal considerations and, to the extent they were aware of problems, why they didn't fix these flaws and ambiguities? Instead they relied, or perhaps over-relied, on extra-legal forces and constraints.

The answer comes from another force: path dependency. The private equity structure, the boiler-plate of private equity, appears to be one largely set by path dependencies.²¹⁵ But, the structure's stickiness is not primarily a result of network effects and excess transactional switching costs – the most commonly cited reasons for path dependency in boiler plate.²¹⁶ Rather, it is an agency problem. Private equity lawyers are not incentivized to rethink and renegotiate the boilerplate of private equity, but rather rely upon pre-existing, “good enough” structures. Dependencies in these complex contracts are therefore strong and the structure is particularly resistant to externalized shock.²¹⁷ Accordingly, change when it does happen trends towards the incremental and is likely to be piecemeal upon the existing structure creating further ambiguity and flaw.²¹⁸

A. The Nature of Path Dependency in the Private Equity Structure

In the past twenty years there have been only two significant shifts in the structure of private equity. In the 1990s, equity commitment letters were added and the terms of debt commitment letters enhanced.²¹⁹ In 2005, the

²¹³ See United Rentals Eric Swedenburg Depositions Transcript, at [*].

²¹⁴ *Id.*

²¹⁵ I use the term boilerplate here broadly to include structure as well as contract terms. Cf. Todd D. Rakoff, *Social Structure, Legal Structure, and Default Rules: A Comment*, 3 S. CAL. INTERDISC. L. J. 19, 25 (1993) (“[i]n different social settings different norms are clustered around the practice of contracting itself . . . different norms about how many terms, and which terms, parties should specify.”)

²¹⁶ See Marcel Kahan & Michael Klausner, *Standardization and Innovation in Corporate Contracting (Or “The Economics of Boilerplate”)*, 83 VA. L. REV. 713, 729-36 (1997). The bulk of scholarship in the complex contracting area has been in the context of sovereign wealth bond and the movement to adopt collective action clauses in the indentures for this debt. See Robert Ahdieh, *Between Mandate and Market: Contract Transition in the Shadow of International Order*, 53 EMORY L. J. 691 (2004); Robert B. Ahdieh, *The Role of Groups in Norm Transformation: A Dramatic Sketch, in Three Parts*, 6 CHI. J. INT’L L. 231 (2005); Stephen J. Choi & G. Mitu Gulati, *Innovation in Boilerplate Contracts: An Empirical Examination of Sovereign Bonds*, 53 EMORY L.J. 929 (2004); Anna Gelpern & Mitu Gulati, *Public Symbol in Private Contract: A Case Study*, 84 WASH. U. L. REV. 1627 (2006). See also. For discussion of boilerplate generally, see Omri Ben-Shahar & James J. White, *Boilerplate and Economic Power in Auto Manufacturing Contracts*, 104 MICH. L. REV. 953 (2006); William W. Bratton, Jr., *The Economics and Jurisprudence of Convertible Bonds*, 1984 WIS. L. REV. 667; Claire A. Hill, *Why Contracts Are Written in “Legalese”*, 77 CHI.-KENT L. REV. 59 (2001); Marcel Kahan & Michael Klausner, *Antitakeover Provisions in Bonds: Bondholder Protection or Management Entrenchment?*, 40 UCLA L. REV. 931 (1993).

²¹⁷ The most prominent example is of this in another context is the collective effort involved in shifting sovereign bond terms from unanimous to collective action clauses. See Choi & Gulati, *supra* note 216; Galpern & Gulati, *supra* note 216.

²¹⁸ See Choi & Gulati, *supra* note 216, at 993-94.

²¹⁹ See *supra* notes 56-58 and accompanying text.

SunGard transaction heralded a more substantive change in the structure by spurring adoption of reverse termination fee provisions and elimination of financing conditions.²²⁰ In both instances, though, the changes were incremental; the transactional equivalent of adding a new room onto a house rather than demolishing the home to rebuild. Rather than a fundamentally new configuration, these revisions rested upon the prior structure and still retained its core – externalized financing through limited liability shell vehicles.

At its simplest level, classical law and economics theory would characterize this result as efficient bargaining among the parties. In private equity transactions, the attorneys are sophisticated and well-compensated, transactional costs in negotiating new structures are low and limited largely by the need to complete these transactions in a short time-frame. The private equity structure is thus an efficiently bargained for result and any change in structure explained by shifting equilibrium among the parties; a new, efficient bargain achieved due to events which force the parties to achieve a new bargaining position.²²¹ The private equity structure has changed so little due to the lack of such occurrences.²²²

Path dependency theory recognizes that efficient bargaining may be hindered by the initial structure set by the parties. Thereafter, first agreed terms are “locked-in” and become boilerplate and may persist due to network effects, informational deficits, and signaling effects which create excessive transactional switching costs.²²³ In these later contractual iterations, parties do not renegotiate these terms due to the costs associated with such a change. Thus, later generations of boilerplate may not reflect the bargain parties would necessarily negotiate absent these additional costs; optimal terms thus become sub-optimal or unintentionally sub-optimal terms remain sub-optimal.²²⁴ Apocryphal examples abound in other

²²⁰ See *supra* notes 60-68 and accompanying text.

²²¹ This comports with Professor Gilson’s theory of the transactional attorney as transaction cost engineering structuring a more efficient deal. See Gilson, *supra* note 17, at 253-56. See also *Symposium: Business Lawyering and Value Creation for Clients*, 74 OREGON L. REV. 1 (1995).

²²² Most efficiency theorists still recognize that external transaction costs can hinder an efficient bargain. See, e.g., Ian Ayres & Robert Gertner, *Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules*, 99 YALE L.J. 87, 91 (1989); David Charny, *Hypothetical Bargains: The Normative Structure of Contract Interpretation*, 89 MICH. L. REV. 1815 (1991).

²²³ See Marcel Kahan & Michael Klausner, *Path Dependence in Corporate Contracting: Increasing Returns, Herd Behavior and Cognitive Biases*, 74 WASH. U. L.Q. 347, 353-55 (1996). For a discussion of what exactly path dependency is and its detractors, see Paul A. David, *Path dependence, its critics and the quest for ‘historical economics’*, in *EVOLUTION AND PATH DEPENDENCE IN ECONOMIC IDEAS: PAST AND PRESENT*, edited by P. Garrouste and S. Ioannides. For a more skeptical view See STAN LIEBOWITZ, *RE-THINKING THE NETWORK ECONOMY: THE TRUE FORCES THAT DRIVE THE DIGITAL MARKETPLACE* (2002).

²²⁴ Compare Frederick W. Lambert, *Path Dependent Inefficiency in the Corporate Contract: The Uncertain Case with Less Certain Implications*, 23 DEL. J. CORP. L. 1077 (1988) (arguing that “the case has not been made for the general application of path dependence to the contracting process, but unique attributes of

contexts to support this theory including the continued use of QWERTY keyboards and triumph of Microsoft's Windows systems software.²²⁵

In the private equity market participants describe the private equity structure and its evolution as simply the market norm.²²⁶ This is common terminology negotiators typically utilize in setting the terms of complex contracts. That is, in negotiations attorneys will reference the market – the predominant or preexisting structure or boilerplate utilized by other market participants -- to establish and validate usage of their own terms for the transaction being negotiated.²²⁷ From interviews this appears true of the private equity market also.²²⁸ The pre-August 2007 private equity structure was premised upon and negotiated from the structure utilized by others at the time.²²⁹ In these circumstances innovation is heuristically anchored to the market.²³⁰ Path dependency is created by market participants' paying heed to the market norm and desire not to stray too far.²³¹ In this light, the static nature of the private equity structure thus appears to be explained more by this path dependency than a transactional efficiency story.

This still does not explain the parties' resort to a market norm or whether the norm itself might be efficient. More particularly, given the low legal costs and the sophisticated nature of negotiators in the private equity market, switching costs should not be strong forces in this paradigm. Why should the market hold such sway unless it is indeed the efficient equilibrium?

B. The Stickiness of the Private Equity Structure

Answers to this question again come by looking outside the four corners of the documented private equity structure. Prior to August 2007, market

certain contracts, such as the corporate bond indenture, may exist in a unique environment conducive to path-dependent suboptimality").

²²⁵ See generally Stan Liebowitz & Stephen E. Margolis, *Policy and Path Dependence: From QWERTY to Windows 95*, 18 REGULATION NO. 3, at 33 (1995). In other words, due to path dependency a superior product may not necessarily be the successful one in the market as a result of action by others. These people adopt a different less utility maximizing good thereby creating self-reinforcing feedback loops which engender further adoption of the less-superior good. Brian W. Arthur, *Competing Technologies, Increasing Returns and Lock-in by Historical Events*, 99(1) ECON. J. 116 (1989).

²²⁶ The assumption is that terms as agreed are efficient on their face. See, e.g., King & Smith, *supra* note 29, at 5 citing Robert Daines & Michael Klausner, *Do IPO Charters Maximize Firm Value? Antitakeover Protections in IPOs*, 17 J. L. ECON. & ORG. 83, 85 (2001).

²²⁷ See Russell Korbkin, *Inertia and Preference in Contract Negotiation: The Psychological Power of Default Rules and Form Terms*, 51 VAND. L. REV. 1583 (1998).

²²⁸ See, e.g., Interview A; Interview B.

²²⁹ See *supra* Part I.B.

²³⁰ See Korbkin, *supra* note 227.

²³¹ See Omri Ben-Shahar & John Pottow, *On the Stickiness of Default Rules*, 33 FLA. ST. U. L. REV. 651, 687 (2006). Professors Kahan and Klausner attribute this in part to herd behavior. See Kahan & Klausner, *supra* note 223, at 350-53.

participants relied upon external norms and forces created within the contract itself to complete the private equity structure. Private equity firms were incentivized to complete transactions by reputational constraints; if the firms terminated acquisition transactions they would be seen as unwilling to keep their bargains. In the multi-player, repeat private equity market, after such an event future acquirers would become less willing to transact with them.²³² Moreover, the relationship established by the private equity contract and the bonding, signaling and understandings reached during contract negotiation provided further assurances of transaction completion. In other words, forces outside the contract functioned to provide acquirers with assurances that acquisitions would complete.

Where the contract is only part of the understood bargain, attorneys may be incentivized to choose “good enough” options.²³³ Attorneys stick to the market “norm” rather than engage in further transactional engineering to attempt to further optimize the structure. They do so first because more creative solutions can expose them to criticism. The use of the market structure is less likely to be questioned – its use in other transactions validates it. But a different structure will be noticed in the market and commented upon perhaps negatively. This is a hidden switching transaction cost. Moreover, in negotiating a new structure mistakes or unanticipated events may expose the structure to failure and the innovating attorneys to criticism. Second, attorneys are disincentivized to take this risk since, extra-legal forces and constraints buttress the structure, making it an acceptable one. The result is that attorneys are significantly incentivized to keep to the “market” norm and adhere to boilerplate contractual structures in negotiating complex contracts.²³⁴

These forces mean that innovation is typically based on the prior structure and incremental at best. Attorneys look to add value to transactions, value which can be shown to their clients. But in doing so these lawyers rely upon market norms for guidance and are hamstrung by prior precedent. They seek to add value, but not too much value as

²³² The private equity community is a small one, but the community ties in the private equity industry appear to be lesser than in the type of close-knit community scholars typically cite as a predicate for establishing relational contracting or extra legal dispute resolution mechanisms. *See, e.g.*, ROBERT C. ELLICKSON, *ORDER WITHOUT LAW: HOW NEIGHBORS SETTLE DISPUTES* (1991) (examining extra legal dispute resolution mechanisms in the cattle-ranching community in Shasta County California). *See also* OLIVER E. WILLIAMSON, *THE ECONOMIC INSTITUTIONS OF CAPITALISM: FIRMS, MARKETS, RELATIONAL CONTRACTING* (1985); Holly Raider, *Repeated Exchanges and Evidence of Trust in the Substance of Contracts* (1999).

²³³ Cf. Hill, *supra* note 19, at 70-76 (asserting economic, psychological and other dynamics collectively function to engender imperfect contracts).

²³⁴ *See* Russell B. Korobkin, *Inertia and Preference in Contract Negotiation: The Psychological Power of Default Rules and Form Terms*, 51 *VAND. L. REV.* 1583 (1998); Russell B. Korobkin, *The Status Quo Bias and Contract Default Rules*, 83 *CORNELL L. REV.* 608 (1998)

incentives to truly innovate in relational contracts are reduced since extra-contractual forces will serve to complete the contract; forces which are perceived as strong. Attorney-initiated alterations to boilerplate in complex contracts thus remain within the embrace of the existent market structure. It becomes largely a hard-fought negotiation over the details of terms and wording but not the structure itself. These smaller disputes permit attorneys to show that they are negotiating hard for their clients within the parameters of their ability and desire to do so.²³⁵

Substantive change when it comes is thus likely to be a result of external forces arising outside the traditional legal community.²³⁶ These are akin to the “interpretative shocks” which some have also theorized cause boilerplate to move substantively.²³⁷ Even then the forces mitigating against change in complex contracts work to keep any shift towards the incremental and premised upon the prior structure.²³⁸ This is not a network effect in the sense of normal usage of the term – that the transactional costs of switching prevent change.²³⁹ Rather it is an agency problem – attorney incentives work to hamper change and confine it within the structure itself.²⁴⁰

The evolution of private equity structure, a short-term relational agreement, comports with this theory. The structure has seldom changed over two decades. The largest shift, the implementation of a reverse termination fee structure, came from an externalized source, the credit market. This is not surprising. The credit market has historically been more turbulent and prone to failed transactions.²⁴¹ Moreover, the liquidity wave within the markets in 2005 was unprecedented.²⁴² This drove a shift in the terms of debt commitment letters as lenders, knowing that the debt would subsequently be sold in the market, became remarkably unconcerned with credit risk focusing instead on the saleability of this debt. In interviews with

²³⁵ See Hill, *supra* note 19.

²³⁶ This appears partially at odds with the traditional view of innovative environments which find that high resource, decentralized and open communities are flash points for innovation. See Robert Drazin & Claudia Bird Schnoohoven, *Community, Population and Organizational Effects on Innovation: A Multilevel Perspective*, 39 ACAD. MANAG. J. 1065 (1996). But it does match with theories that posit change as an external force. See RONALD S. BURT, *STRUCTURAL HOLES: THE SOCIAL STRUCTURE OF COMPETITION* (1992)

²³⁷ See Choi & Gulati, *supra* note 216, at 993-94.

²³⁸ See W. Scott Frame & Lawrence J. White, *Empirical Studies of Financial Innovation: Lots of Talk, Little Action*, 42 J. ECON. LIT. 116, 122 (2004).

²³⁹ See Kahan & Klausner, *supra* note 223, at 350-53.

²⁴⁰ See Michael E. Boardman, *Contra Proferentem: The Allure of Ambiguous Boilerplate*, 104 MICH. L. REV. 1105 (2006) (postulating that drafters of boilerplate may persist in writing ambiguous or confusing terms due to prior court interpretations which clarify this language).

²⁴¹ For example, the late 1980s collapse of the high yield market almost bankrupted First Boston and forced it into an acquisition transaction with Credit Suisse. See *The Burning Bed*, BUSINESS WEEK, May 1990.

²⁴² See Speech of Governor Kevin Warsh at the New York University School of Law Global Economic Policy Forum, New York, New York, *Financial Market Turmoil and the Federal Reserve: The Plot Thickens* (April 14, 2008).

market participants this shift created value for the private equity firms allowing them to negotiate firmer debt commitment letters.²⁴³ Acquirees in private equity captured some of that value in negotiations to foster the 2005 shift in the private equity structure.²⁴⁴

The change in the private equity structure was thus a response to events in the related credit market. The additional value accrued to private equity firms was in part seized by lawyers for acquirees.²⁴⁵ However, the private equity lawyer was incentivized to graft any changes onto the pre-existing structure. Thus, the reverse termination fee structure was placed onto the pre-2005 private equity structure which permitted acquirers to terminate the acquisition agreement in the event of a MAC to the acquiree company.²⁴⁶ The material adverse change mechanic was itself one that was initially inserted into the structure in the 1980s borrowed at that time from agreements for strategic transactions.²⁴⁷ In grafting these new terms onto the private equity structure, lawyers underestimated and failed to fully account for the issues surrounding this structure and its adaptability. Instead, they relied upon “good enough” solutions and extra-legal constraints and understandings to complete the new structure. The result was the flawed structure exposed by the recent wave of litigation.

Additionally, the need of attorneys to bargain and show value within the bounds of structure played out in the evolution of private equity in the pre-August diffusion of choice among reverse termination fee structures.²⁴⁸ This explains the bargaining and diffusion of deal structure among a pure reverse termination deal with a single or two-tiered reverse termination fee versus a specific performance termination fee. Negotiating these variations allowed private equity attorneys to show value and for private equity firms to signal their intentions within the bounds of the contract.²⁴⁹

Another example of negotiation with the bounds of the structure

²⁴³ See Leinwand and Goldfeld, *supra* note 161, at 1. See also *Breaking Up is Costlier to Do*, M&A: DEALMAKERS J., Apr 1, 2007 (“The prevalence of these fees is connected to the availability of capital, deal attorneys say.”)

²⁴⁴ See Sorkin & Swedenburg, *supra* note 50, at 2.

²⁴⁵ See Interview C and *supra* notes 60-68 and accompanying text.

²⁴⁶ See *supra* notes 60-68 and accompanying text.

²⁴⁷ See Ronald J. Gilson & Alan Schwartz, *Understanding MACS: Moral Hazard in Acquisitions*, 21 J.L. ECON. & ORG. 330 (2005).

²⁴⁸ See *supra* notes 60-68 and accompanying text.

²⁴⁹ This micro-variation is exacerbated by the “battle of the forms” which occurs in each transaction. Each major private equity law firm has their own form for the transaction, and each form is structured similarly but is written in a different style and with slightly different wording for each of the common clauses. In the digital age there is much more of a merging of the forms, rather than a dominant form based on who writes the first draft. Each lawyer will work to make the contract more familiar and comfortable to himself. The result is oftentimes pidgin.

occurred among choice of law clauses. Private equity contracts began to more frequently use Delaware for their choice of law after an adverse decision rendered in 2005 in *Consolidated Edison v. Northeast Utilities*²⁵⁰ limited the ability of acquirers to sue under New York law for monetary damages for lost premium when an acquirer breached an acquisition agreement.²⁵¹ In order to ensure certainty on this issue, Delaware subsequently became the preferred choice of law for private equity contracts.²⁵² Lawyers thus viewed this contract change as an easy one that could show their knowledge and ability to structure contracts in light of the law. This was further illustrated on the less frequent occasions when private equity actors elected to have their contracts governed by New York law. In those instances parties sometimes added specific language to address the *Consolidated Edison* case.²⁵³ But again, the piecemeal and incomplete nature of change in the private equity structure came back to haunt participants – the shift to Delaware choice of law clauses failed to account for the continuing use of New York choice of law clauses in debt commitment letters resulting in multiple causes of actions under different laws in a number of private equity litigations. Lawyers simply failed to account for the interaction of these differing law and forum clauses in the event of litigation.²⁵⁴

The need for attorneys to show value also explains how changed terms in these complex contracts diffuses. In *SunGard* the transaction involved the top law firm of Simpson Thacher.²⁵⁵ Their involvement as the initiators can be explained by their prominent role as counsel in many private equity transactions: Simpson was counsel on approximately 21% of all public private equity deals with a value greater than \$100 million from January 1, 2004 through August 1, 2007.²⁵⁶ The structure had been used intermittently

²⁵⁰ 426 F.3d 524 (2d Cir. 2005).

²⁵¹ The *Con Ed* case held that neither an acquirer nor its shareholder could sue an acquirer for the premium agreed to be paid on their shares under an acquisition agreement. *Id.*; see also Miller, *supra* note 162.

²⁵² I find that from 2005-2007, [●]% of private equity contracts had a Delaware choice of law and [●]% a New York choice of law. Mergermetrics Database (all deals over \$100 million). [My findings find the reversal of the trend found by Professors Eisenberg and Miller against Delaware law in acquisition agreements. See Theodore Eisenberg and Geoffrey Miller; *Ex Ante Choice of Law and Forum: An Empirical Analysis of Corporate Acquisition agreements*. 59 VAND. L. REV. 1975 (2006). – to be confirmed]

²⁵³ See, e.g., Agreement and Plan of Merger among NuCO2 Acquisition Corp., NuCO2 Merger Co. and NuCO2 Inc., at Sec. 9.02, dated as of January 29, 2008, available at http://www.sec.gov/Archives/edgar/data/947577/000092189508000276/ex21to8k01124_01292008.htm

(acquisition agreement under New York law adding language that in the case of breach of the agreement “shall not be limited to the Expense Reimbursement Amount and may include the benefit of the bargain of the Merger to such party (and, in the case of the Company, its stockholders), adjusted to account for the time value of money”).

²⁵⁴ It was likely these complications which led Penn National Gaming to agree to terminate its own acquisition transaction with Fortress and Centerbridge. Penn had a specific performance form of acquisition agreement, but the prospect of multiple litigation in differing forums likely led it to agree to settle.

²⁵⁵ See Exhibit 99.1 to SunGard Current Report on Form 8-K, dated Mar 27, 2007, available at <http://www.sec.gov/Archives/edgar/data/789388/000119312505061716/0001193125-05-061716-index.htm>.

²⁵⁶ For private equity transactions over \$100 million of public acquirers. Author calculations from

in prior transactions, but the use in such a historic transaction by these significant firms validated it for use by other parties.²⁵⁷ In fact, Simpson publicly promoted its work on this structure in order to highlight its innovative nature.²⁵⁸ The quick adoption reflected the widespread number of private equity participants in the SunGard transaction, the competitive nature of the private equity market which made this innovation seem more attractive in the market and the desire of top law firms to “compete” by offering this innovation as a product developed by them.²⁵⁹ Here, change in the private equity context appears to diffuse much quicker than in other studied areas of corporate innovation such as the poison pill.²⁶⁰ This is likely due to the smaller private equity legal community and their ability as sophisticated parties to rapidly respond to change.²⁶¹ Again, though, this change was one that ultimately was incremental and brought on by external forces. So, the change was ideal for adoption. It was pronounced by the leading private equity participants and an incremental change that other market participants were likely to find within the market norm and therefore less risky to adopt.

This notion of change – that it comes from the top down rather than from external innovators in the complex contracting model – is one that is driven by the structure of the private equity industry.²⁶² In the private equity model barriers to entry are high. The attorneys who regularly represent the private equity firms and their acquirers are sizable, prominent law firms who have the capacity to negotiate these transactions in a timely manner and are familiar with market nuances. New entrants are unable to offer these skills, lack validation in this market and are a signal of inexperience by the party hiring them and thus are largely prevented from entry. Moreover, when they do enter into the game, these new firms typically represent acquirers on a one-off basis.²⁶³ Any innovation by them is not protected

MergerMetrics Database. See Choi & Gulati, *supra* note 216 (citing the role of Cleary Gottlieb in effecting change to unanimous consent clauses in sovereign wealth bond indentures).

²⁵⁷ Here, the fact that the structure was publicized by Simpson Thacher may have been as a vehicle to promote their own private equity clients as providing a superior transaction structure in competitive bidding situations.

²⁵⁸ See Sorkin & Swedenburg, *supra* note 56.

²⁵⁹ See Michael J. Powell, *Professional Innovation: Corporate Lawyers and Private Lawmaking*, 18(3) L & SOC’Y INQ. 423, 433-39 (1993) (discussing Wachtell Lipton’s marketing efforts for its poison pill innovation).

²⁶⁰ See David Strang & Sarah Soule, *Diffusion in Organizations and Social Movements: From Hybrid Corn to Poison Pills*, 24 ANN. REV. SOC. 265 (1998). See also Gerald F. Davis, *Agents Without Principles? The Spread of the Poison Pill Through the Intercorporate Network*, 36 ADMIN. SCI. Q. 583 (1991).

²⁶¹ There is a similarity to the venture capital community in the size and cohesiveness of private equity. See Mark C. Suchman, *On Advice of Counsel: Law Firms and Venture Capital Funds as Information Intermediaries in the Structuration of Silicon Valley* (1994) (unpublished Ph.D. dissertation, Stanford University).

²⁶² This jibes with those who have described innovation in a world of unpatentable ideas as driven by those who dominate the market and can therefore profit maximally from such innovation. See Frame & White, *supra* note 238, at 119.

²⁶³ From 2004-August 1, 2007, 16.2% of law firms represented an acquirer or acquiror more than five times while 62.6% did so only once. Author calculations from Mergermetrics database for public private equity

intellectual property and a public good. It can be quickly taken advantage of by other, more prominent firms who can capture more value from such innovation.²⁶⁴ These outsiders are therefore not highly incentivized to innovate, lack economy of scale and being previously unfamiliar with the structure they resort to the market “norm”. Here, their incentives are similar to more experienced lawyers who do not want to take the risks of deviating from current structure. This is a risk that is heightened in the case of newcomers since deviation is more apt to be viewed as a result of inexperience rather than true innovation.²⁶⁵

C. Law Firm Centrality and the Private Equity Structure

The private equity world is a discrete one, and a few select law firms represent the majority of acquirees and private equity acquirers.²⁶⁶ This circumstance can also function to further hamper and forestall innovation and change. The following chart sets forth the legal representation of private equity firms and acquirees in all private equity buy-outs greater than \$100 million from January 1, 2004 through August 1, 2008:

transactions greater than \$100 million in value.

²⁶⁴ See Suchman, *supra* note 197, at 105.

²⁶⁵ The model put forth here may be at odds with events in other corporate arenas such as change and innovation in the venture capital community. There, the unique innovational mindset of the industry participants and separation from the East coast law firms nurtured a unique model erected by external law firms. See Mark A. Suchman, *The Contracting Universe: Law Firms, Venture Capital Funds and the Institutionalization of New-Company Financing in Silicon Valley*. See also Michael J. Powell, *Professional Innovation: Corporate Lawyers and Private Lawmaking*, 18(3) L & SOC’Y INQ. 423 (1993).

²⁶⁶ See also Mark C. Suchman & Mia L. Cahill, *The Hired Gun as Facilitator: Lawyers and the Suppression of Business Disputes in the Silicon Valley*, 21 L. & SOC. INQUIRY 679, 683 (1996) (Silicon Valley venture capital lawyers “[t]hrough their relations with both entrepreneurs and investors, they identify, create, transmit, and enforce the emerging norms of the community facilitating what might otherwise be prohibitively costly, complex, and unpredictable transactions.”)

Chart IVA²⁶⁷

	<i>Both Acquiree and Acquirer Represented By Top Private Equity Law Firm</i>	<i>Neither Acquiree nor Acquirer Represented By Top Private Equity Law Firm</i>	<i>Either Acquiree or Acquirer Represented By Top Private Equity Law Firm</i>	<i>Only Acquiree Represented By Private Equity Law Firm</i>	<i>Only Private Equity Firm Represented By Top Private Equity Law Firm</i>
Transaction Size >\$500 Million	39.66%	3.91%	20.67%	4.47%	16.20%
Transaction Size <\$500 Million	12.29%	5.03%	18.44%	5.03%	13.41%
Total of all Private Equity Transactions from 1/1/2004- 8/1/2007	51.96%	8.94%	39.11%	9.50%	29.61%

Chart IVA reveals that representation of private equity firms is highly concentrated and a core group of 22 law firms represented a private equity firm in approximately 81.5% of transactions and were involved in 91.07% of all transactions.²⁶⁸ Six firms were ubiquitous during this time period and involved in the majority of transactions:

Chart IVB²⁶⁹

<i>Law Firm</i>	<i>Law Firm Represented Acquiree</i>	<i>Law Firm Represented PE Firm</i>	<i>Total Transactions Involved</i>	<i>Percentage of all PE Transactions from Jan. 1, 2004-Aug. 1, 2007 >100 MM</i>
Simpson Thacher	8	29	37	21%
Skadden Arps Meagher Slate & Flom	18	16	34	19%
Wachtell Lipton Rosen & Katz	16	12	28	16%
Kirkland & Ellis	5	14	19	11%
Latham & Watkins	11	7	18	10%
Ropes & Gray	3	15	18	10%

²⁶⁷ Author calculations from Mergermetrics database. 129 law firms were involved in 192 public private equity transactions with a value greater than \$100 million during this time period. Top Private equity firms are the 22 firms out of 129 firms involved in private equity deals and who had six or greater representations on a private equity deal during the applicable time period.

²⁶⁸ *Id.*

²⁶⁹ *Id.*

As Charts IVA and IVB show, in this specialized market private equity firms have a stable of law firms they repeatedly retain. These law firms are highly experienced in negotiating and familiar with the structure of private equity. This additionally incentivizes these firms to represent their clients through the possibility of repeat business opportunities.

This trend persists for acquirees. Chart IVA shows that acquirees were represented by a top private equity law firm in 61.4% of transactions. However, this figure is lower than private equity firms due to acquiree preferences for their traditional counsel for representation.²⁷⁰ These non-top firms are not as experienced in and likely not as familiar with the private equity structure. Of the 129 law firms I found represented a party in a private equity transaction during the time period January 1, 2004-August 1, 2007, 63 provided legal advice in only one private equity transaction.²⁷¹ And outside the top 22 law firms these other 107 law firms represented a acquiree 69.2% of the time and a private equity firm 30.8% of the time.²⁷²

In the case of these non-top law firms, acquirees may not obtain equivalent legal advice. The firms are often smaller and lack the skill-set and ability to make the appropriate investments to understand and innovate with respect to the structure of private equity. Moreover, as discussed *supra* their incentives to do so in these circumstances are low.²⁷³ These non-top law firms are unlikely to obtain further private equity representations, and they are likely losing part of their client business as a consequence of the sale. Because of the need for this experience, acquirees still in a majority of circumstances retained a top private equity firm, versed in the structure of private equity. However, the top law firms' economic incentives may be skewed: their primary clients are the private equity firms who provide repeat business. Accordingly, the incentives of the top law firms to innovate or otherwise challenge their clients and push for a structure that would harm their ability to further obtain private equity business are further lowered.²⁷⁴ Thus, the particular nature of the private equity legal field may combine with the other described forces to prevent substantive innovation to the current private equity structure, to the detriment of acquirees.²⁷⁵ Reliance of

²⁷⁰ This may be due to, among other things, relationship specific investments which incentivize acquirees in these circumstances to use their traditional counsel. See Michael Klausner et al., *The Law And Economics Of Lawyering Second Opinions In Litigation*, 84 Va. L. Rev. 1411 (1998).

²⁷¹ Author calculations from Mergermetrics database.

²⁷² *Id.*

²⁷³ See *supra* notes 262-265 and accompanying text.

²⁷⁴ See MACKLIN FLEMING, *LAWYERS, MONEY AND SUCCESS* (1997); Lisa Bernstein, *The Silicon Valley Lawyer as Transaction Cost Engineer?*, 74 OR. L. REV. 239, 248 n.43 (1995).

²⁷⁵ See generally Gillian Hadfield, *Legal Barriers to Innovation: The Growing Economic Cost of Professional Control Over Corporate Legal Markets*, 60 STAN. L. REV. 102 (2008).

attorneys on extra-contractual forces works to cover for this possible conflict by allowing acquiree attorneys to otherwise justify the structure of private equity. I believe that this potential conflict did not affect attorney bargaining on granular issues – law firms still attempted to show value to their clients. Rather reliance on extra-contractual forces permitted acquiree attorneys to forgo innovating and bargaining over more favorable unfamiliar terms. This additional potential agency conflict was thus likely not a determinant force in setting the structure and terms of private equity but rather a reinforcing one.²⁷⁶

D. The Optimality of the Private Equity Structure

The question remains as to whether the private equity contract was an “optimal one”. But the role of and forces upon attorneys and the nature of change in private equity contracts belie a term like optimal.²⁷⁷ In efficient bargaining without transaction costs or other external drags sophisticated, well-represented parties can negotiate optimal contracts. Here, I define an optimal contract as an efficient bargain which does not produce excess, unanticipated transaction costs or an uneconomical remedy for a foreseeable eventuality.²⁷⁸ The structure of private equity does not meet this test. Due to attorney agency costs, it is a path dependent structure resistant to change and created piecemeal upon the pre-existing structure.²⁷⁹ The private equity structure is also one that inherently and necessarily relies on extra-legal forces to complete it. If these external forces fail they are likely to expose the flaws permeated within the structure. The post-2007 August events affecting the private equity structure provided very real proof of this. The structure of private equity is thus a suboptimal bargain.

V. THE FUTURE OF PRIVATE EQUITY

The private equity attorney as agent and transaction cost engineer is more than just a scrivener, negotiating words in a contract. The attorney, together with his or her principal, weighs the wording of the contract

²⁷⁶ Evidence for this comes from the United Rentals litigation. In that transaction Simpson Thacher represented the acquiree; from the trial transcripts it appeared to be bargaining hard within the bounds of the current private equity structure. *See supra* at Part III.A.2.

²⁷⁷ *See, e.g.,* Kahan & Klausner, *Standardization and Innovation*, *supra* note 216, at 750-51 (arguing that the “put at par” event risk covenant feature in bond indentures was suboptimal).

²⁷⁸ Others simply define “suboptimal” or “optimal” as a faulty bargain that is unfavorable to one party in its overt economics. *See, e.g.,* Choi & Gulati, *supra* note 216, at 940-943 (discussing the debate over whether unanimous consent clauses in sovereign wealth bond indentures are “suboptimal”); Kahan & Klausner, *Standardization and Innovation*, *supra* note 60, at 751 (“[t]he remedy provided to bondholders in most covenants is a put at par. This, however, is a faulty remedy [since] the put would overcompensate bondholders and possibly deter efficient transactions.”)

²⁷⁹ *See* Henry T. Greely, *Contracts as Commodities: the Influence of Secondary Purchasers on the Form of Contracts*, 42 VANDERBILT L. REV. 133 (1989).

against other legal and non-legal factors. The attorney then drafts the contract to reflect this weighing, confirming their impressions through the dialogue and bonding of the negotiation itself.²⁸⁰ The private equity contract is thus a complex contract, and like all such contracts is dependent upon outside forces to finish it. The contract terms function together and interact with external norms and constraints to form a fuller bargain. This bargain is greased by the relational bonding and signaling that occurs between transactional participants and their representatives in the negotiation of the transaction and which continues even as the relationship breaks down. But due to the nature of the private equity structure the contract is often ambiguous in nature or otherwise flawed in its terms.

Prior to August 2007, these flaws and ambiguity were accepted for a number of reasons. First, lawyers appeared to rely on norms and external and contractual constraints to complete the private equity structure. Attorneys were thus not incentivized to restructure or fix the private equity structure. Second, the old structure had been validated and the new mechanics of the post-2005 structure were “good enough” -- able to get to deal completion. Further negotiation over these particular structural terms appeared unnecessary given the past success of the structure and the perception that the new one was incrementally better and created more certainty. Third, to the extent these flaws actually created uncertainty they allowed acquirees and their attorneys to achieve a desired result – a deal -- while preserving an option for further, later negotiation. Finally, the nature of legal representation in the private equity world – where the top firms provide the bulk of legal advice and repeatedly represented both acquirees and private equity firms likely functioned with these other factors to inhibit any challenge to or innovation within the structure.

In this light, the post-2007 private equity implosion was a failure of lawyers, particularly those for acquirees, to properly assess risks and to innovate. Lawyers and other transaction participants failed to predict the effects of a mass market disruption as occurred in August 2007 and onwards.²⁸¹ In other words, acquiree lawyers as agents over-relied on these external forces to forgo innovative approaches to bridge the pre-existing closing gap and “fix” the flaws in the private equity contract despite the low transaction costs to do so. This over-reliance may have been enforced by the

²⁸⁰ Cf. Michael J. Powell, *Professional Innovation: Corporate Lawyers and Private Lawmaking*, 18 LAW & SOC. INQUIRY 423 (1993).

²⁸¹ See Megan Davies and Jessica Hall, *Buyout spats bruise many, damage trust*, Jul 7, 2008, available at http://biz.yahoo.com/rb/080707/dealtalk_buyouts.html?v=3 (quoting Marilyn Sonnie, a partner at law firm Jones Day stating that "Boards never really thought they were signing up for a deal that could just evaporate But a lot of them did.")

confined nature of the private equity legal community which may have biased the structure in favor of private equity firms. There may not even have been over-reliance -- the market disruption may not have been predictable or otherwise rationally contemplated at the time these pre-August contracts were negotiated. If so, the failure to innovate and sloppy drafting practices may be explained by the perceived low probability of such mass disruption which made the costs of such further innovation not worthwhile. While these explanations no doubt played a part and are what attorneys are likely to cite as the reason, they are belied by future events in the world of private equity.

If the failure of private equity was a failure of calculus with respect to norms and externalized forces, you would predict that lawyers would reassess these forces in light of post-2007 events. You would further predict that this calculus would militate a shift towards contractual certainty in the private equity structure. Indeed, in the wake of this collapse, commentators and market participants speculated that the structure would be entirely transformed to become significantly more favorable to acquirers.²⁸²

So far, this is not what has happened. Instead, the private equity structure has shifted in the opposite direction towards a more-private equity favorable model. Every one of the private equity transactions announced in 2008 has utilized a pure reverse termination fee structure.²⁸³ This is a telling response. The nature of this shift marks a recognition that the drivers to closing in a private equity transaction substantially exist outside the contract language.²⁸⁴ It also represents a collapse of the bargain between private equity firms and acquiree companies which permitted more rigorous forms of the reverse termination fee structure to exist.²⁸⁵

The response of acquirers and their attorneys fits within a path dependent model of private equity. In this scenario, attorney innovation may not be as appealing since it will again be subject to scrutiny and failure.

²⁸² Interview D. See also Andrew Ross Sorkin & Michael J. de la Merced, *The fine Art of Dealmaking Gathers Dust*, THE N.Y. TIMES, Apr 2, 2008, at 8 (reporting that "Sixty-two percent of the respondents to the Brunswick poll said that reverse termination fees, payments that acquirers can use to walk away from deals, will be tightened or amended over the next year."); Bird, *supra* note 83 (discussing seller expectations for tighter deals in the private equity market)

²⁸³ As of June 26, 2008, there were 11 of these transactions in value greater than \$200 million. Mergermetrics database. See also Steven M. Davidoff, *The More Things Change*, N.Y. TIMES DEALBOOK, Jan. 25, 2008, available at <http://dealbook.blogs.nytimes.com/2008/01/25/the-more-things-change/>

²⁸⁴ Moreover, within the transactions agreed to in 2008 there was an observable "cleaning-up" of language. See Email from Alan Fishbein, dated June 9, 2008.

²⁸⁵ This supports the view that the pre-August 2007 reverse termination fee structure represented a negotiated bargain between private equity and acquirers wherein private equity acquirers gave up contractual leverage in reliance upon external forces. The latest form of private equity structure is merely private equity firms eliminating this overlay.

By negotiating within the prior structure and instead relying upon externalized forces lawyers allow the burden of failure to be assumed by the companies rather than lawyers themselves. Again, we have an agency cost. Because of this though, the role of relational bonding in the contract stage becomes even more important. Not only are companies self-selecting for acquisitions, they need to ensure that the external forces to closing will hold.²⁸⁶ Anecdotally from transaction descriptions from the post-2008 transactions this appears to be the case. It is no surprise that the 2008 private equity deals thus far have been in industries less affected by the market disruption. Acquirees justified using the reverse termination fee structure due to their stable cash generative business models which would make them less resistant to any adverse impact by the economic crisis. This would ensure that their business remained stable and the private equity acquisition would complete.

Relatedly, in the post-August 2007 litigation private equity firms appeared to repeatedly be able to find some clear or less than clear contractual or legal basis to attempt to terminate their agreements. The failure of private equity shows the importance of extra legal forces in gluing together transactions. In complex transactions there will always be limits to what attorneys can do, at some point further additions or revisions to the contract are constrained by bounded rationality or are otherwise hampered by time constraints or other transaction costs. This may always mean that there is some hook that an acquirer can find to terminate a transaction. In other words, when a dispute arises lawyers are always reasonably certain in the complex contract context that they can find some flaw to litigate.²⁸⁷ This type of behavior was clearly on display in the private equity failures of the past year. The consequence is that in the private equity context, and likely complex contracts generally, norms are an important and inescapable component of a contract.²⁸⁸

This combined with the other limitations in the private equity structure have worked to make the response to the events of August 2007 a muted one. The pure reverse termination fee model so far appears to have remained and become the sole breed of the private equity structure. In fact, it has even been enhanced in certain instances by additional conditionality such as EBITDA conditions.²⁸⁹ The specific performance model has been

²⁸⁶ This likely explains the first instance where the private equity structure was utilized in a significant strategic transaction, Mars' agreement to acquire Wrigley. See Steven M. Davidoff, *Wrigley and the Future of M&A*, N.Y. TIMES DEALBOOK, May 1, 2008, available at <http://dealbook.blogs.nytimes.com/2008/05/01/wrigley-and-the-future-of-ma/>.

²⁸⁷ Interview Y.

²⁸⁸ The issue with private equity is thus not reliance on extra-legal norms but over-reliance.

²⁸⁹ An EBITDA condition is a condition that the acquiree will met a set acquiree for earnings before

completely abandoned. As with other change in the private equity structure, this will likely remain the case until some externalized change results in a bigger shift.²⁹⁰

Lawyers still act within this confined structure in order to show value to their clients. Within the model painted in this Article, you would predict that this would lead to the fixing of some of the drafting ambiguities and other smaller defects in the private equity model. This is what appears to have happened – in the 2008 transactions announced thus far the contract language appears to be clearer and more carefully drafted.²⁹¹ In addition, many of the other flaws in the private equity model appear to be addressed. The scope of MAC clauses has been expanded to partially address the problem of its interaction with reverse termination fee clauses. Reverse termination fees have varied more and crept higher in amount. “Reasonable best efforts” clauses appear to have been enhanced by making the reverse termination fees payable upon the failure of the transaction due to regulatory reasons providing a stick to force the cooperation of private equity funds. The response is an expected one based upon the forces driving private equity – the flaws in private equity that otherwise are easy to fix – the transaction costs to doing so are low. The fundamental structure, though, remains.²⁹²

CONCLUSION

The conclusions of this Article are necessarily early. The full consequences of the past years’ shock to the structure of private equity are yet to be fully known. Moreover, the complete response of the private equity participants and its effect on the structure of private equity will likely only be achieved once the market returns to stability in the coming years. Yet, the window on the private equity structure opened by this shock has already informed our understanding of how these complex contracts are negotiated, agreed and evolve. The private equity attorney as transaction cost engineer relies upon more than just the words of the contract and law,

interest, taxes, depreciation and amortization (EBITDA) before the buy-out can be consummated. *See, e.g.*, Agreement and Plan of Merger, dated as of June 15, 2008, by and among QGF Acquisition Company Inc., QGF Merger Sub Inc. and Greenfield Online, Inc., Sec. 6.02, available at <http://www.sec.gov/Archives/edgar/data/1108906/000095012308006885/y60673kexv2w1.htm>.

²⁹⁰ This likely will come from competition from strategic acquirers willing to offer a more certain transaction structure.

²⁹¹ *See* David Marcus, *Desperately Seeking Certainty*, THEDEAL.COM, July 18, 2008, at <http://www.thedeal.com/newsweekly/features/desperately-seeking-certainty.php>

²⁹² Still, I believe the story of the Failure of Private Equity supports the neoformalists. [Flesh this point out] *Compare* William J. Woodward, *Neoformalism in a Real World of Forms*, 2001 WISCONSIN LAW REVIEW 971 (arguing that neoformalism lacks persuasive empirical evidence that it will “cause” people to take more care in making or reading contracts).

but also on norms, conventions, bonding and other extra-legal factors to complete contracts. However, the structure of private equity is not an efficient transactional structure. Reliance, and perhaps over-reliance, on these extra-legal forces create a path dependent structure which dampens innovation, covers up possible attorney inefficiencies and conflicts and allows flaws to creep into the private equity contract. The failure of private equity shows the limitations and failures of lawyering. Preliminary response of attorneys to the private equity implosion confirms this and also informs our view about the nature of change and response to contract structure and terms. Only in the light of ensuing years, though, will we be able to confirm whether the forces and failures cited and discussed here continue to drag on the structure of private equity.²⁹³

²⁹³ The failure to innovate in response to this shock is not only affecting acquirees, but also private equity firms who due to their reliance on optional structures cannot now effectively compete for acquisitions. *See* Vival Monga, *Blackballed*, THE DEAL, Jun 6, 2008 (reporting that “[w]hen Royal Bank of Scotland Group plc announced last month that it would sell its insurance business, it took the remarkable step of excluding private equity firms from the auction” due to the uncertainty embedded in their acquisition agreements).

APPENDIX A
Selected Terminated and Renegotiated Private Equity Transactions
(Aug. 2007-Aug. 2008)

Ann. Date	Acquiree	Acquirer	Outcome
Nov, 16, 2006	Clear Channel	Bain/Thomas H. Lee	Renegotiated
Mar. 7, 2007	PHH	GE Capital Solutions / Blackstone	Terminated (Settlement Agreement)
Mar. 7, 2007	ACS	CEO led MBO / Cerberus Capital	Terminated
Apr. 7, 2007	Sallie Mae (SLM Corp)	JC Flowers consortium	Terminated (Settlement Agreement)
Apr. 7, 2007	Clear Channel TV Stations	Providence Equity Partner	Renegotiated
Apr. 7, 2007	Myers Industries	Goldman Sachs Capital Partners	Terminated (Settlement Agreement)
Apr. 7, 2007	Harman	KKR / Goldman	Terminated (Settlement Agreement)
May 7, 2007	Acxiom Corp.	ValueAct Capital / Silver Lake	Terminated (Settlement Agreement)
May 7, 2007	Alliance Data Systems	Blackstone	Terminated
Jun. 1, 2007	CKX, Inc.	19X, Robert X. Sillerman and Simon Fuller	Terminated
Jun 4, 2007	Accredited Home Lenders Holding Co.	Lone Star Funds	Renegotiated
Jun. 7, 2007	Penn National Gaming Inc.	Fortress Investment Group and Centerbridge Partners LP	Terminated (Settlement Agreement)
Jul. 7, 2007	Reddy Ice Holdings	GSO Capital Partners	Terminated (Settlement Agreement)
Jul. 7, 2007	United Rentals	Cerberus Capital Management	Terminated
Aug. 7, 2007	NetSpend	Capital One Financial	Terminated

Jun 30, 2007	BCE, Inc.	Teachers Private Capital, Providence Equity Partners Inc. and Madison Dearborn Partners, LLC.	Renegotiated
Jul, 25, 2007	Cumulus Media, Inc.	Merrill Lynch Global Private Equity	Terminated
Sep 7, 2007	3Com	Bain / Huawei	Terminated