

# Delaware Law Weekly

November 12, 2008

Volume 11, Number 46 \$10.00

An incisivemedia publication

## Tough Love for Lawyers at Lecture on Private Equity

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*Of the DLW*

While the brewing economic storm was a big factor in the cascade of failed private equity deals that stretched from late 2006 through 2007, the attorneys don't come away clean, according to University of Connecticut law professor Steven M. Davidoff.

Davidoff delivered the visiting scholar lecture at Widener University School of Law Oct. 30. A visiting professor at the Moritz College of Law at Ohio State University this year, Davidoff writes for the *New York Times DealBook*. He previously worked as a corporate attorney with Shearman & Sterling.

Vice Chancellor Leo E. Strine Jr. also commented on the lecture.

Systemic problems arose after the explosion in private equity deals, Davidoff said. In the article on which the lecture

was based, called "The Failure of Private Equity," Davidoff charted 16 crashed deals, including United Rentals Inc./Cerberus Capital Management, which was adjudicated in Delaware. The article is to be published in the *Southern California Law Review*.

First acknowledging the trouble in the credit markets, Davidoff then said, "We are here to talk about the lawyers."

Davidoff said a number of issues affected the lawyers during the negotiation of these deal agreements that may have undermined the position of the target or acquiree. Here are some highlights.

One element was sloppy drafting. Davidoff cited the URI case as an example. In that 2007 case, Chancellor William B. Chandler III had to resolve a conflict between two parties to a failed deal about whether the contract allowed specific performance, court documents show.

The contract had a reverse termination

fee. URI said it was entitled to specific performance. Cerberus, who set out to acquire URI through some shell subsidiaries, said it was a pure reverse termination fee. Chandler found the contract ambiguous but denied URI's petition for specific performance based on extrinsic evidence that revealed URI should have known that Cerberus' expectation was that specific performance was not an option.

"What appeared to be [a] mistake by one party led to ambiguity," Davidoff said during his lecture.

This was only one among quite a few deals. As more private equity buyers walked away, they began to take less of a hit to their reputations, which undermined one of the things that lawyers had assumed would make buyers work as hard as they could to close deals, Davidoff explained.

"The reputational norm was now diminished," he said.

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## Lecture

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The lawyers may have also assumed economic factors would work to help consummate deals, Davidoff notes in his paper.

"Acquirees advised by their attorneys concluded that the contractual terms themselves were enhanced by the normative and economic incentives and constraints existent. In such circumstances, 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 because of reliance upon extrinsic forces and the consequent perceived unavailability of a better bargain," the paper says.

Sloppy drafting is also related to what Davidoff called "path dependency," defined as the tendency everyone has to do what they have always done, or something close to it.

The lecture touched on an innovation by Shearman & Sterling when a private equity consortium went to buy SunGard Data Systems. This deal closed in 2005.

The contract removed the financing condition and gave birth to a reverse termination fee of about 3 percent, Davidoff said. He added that it was an improvement because before, if financing fell through, a target company "got bupkis. The reverse termination fee gave them something."

Later, problems emerged because these fee clauses were often cobbled onto existing private equity deal boilerplate, resulting in contradictory provisions, including choice of law provisions, where one would indicate Delaware, and the other New York.

"I'm not here to say these were all flaws or that people didn't know about it at the time," Davidoff said. "They knew in negotiating the reverse termination fee it created an incentive to walk. I'm convinced the [M&A titans] of the world knew what they were doing. I'm sure they said, 'We never had a deal fail before.'"

They didn't want to take the time to redraft. They may have figured it was good enough, Davidoff said.

"Maybe it was just a failure to innovate. We had this model and we were grafting on provisions and we never asked is there something that would work better," he said.

"He's put his finger on an incontestable point," said Lawrence A. Hamermesh, professor of law at Widener's Institute of Delaware Corporate Law. "It sure looks as if some of these merger agreements were written with provisions that just don't work."

In particular, Hamermesh said, they don't work in terms of how and when they can unwind and what the remedies are.

"His related point is that there was a bubble, and there was an illusion that these deals wouldn't unravel and that private equity buyers wouldn't walk away because of reputational concerns. Obviously that has proven not to be so," Hamermesh said. "The result is that it has put a lot of pressure on the courts to hack through the jungle of entwined provisions that seem to go in opposite directions."

After the minutely detailed lecture, Strine praised the paper as excellent but said Davidoff "was a bit hard on the lawyers."

Strine said he thought, mostly, lawyers knew the risks.

"What I love is that the targets were getting more protection than they ever

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# Lecture

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had. We can say that lawyers for targets didn't do as much as they could have," but more than previous generations, he said.

Despite the list of failed deals, Strine noted, there is perhaps a longer list "of people who got in under the wire. These were very plush valuations."

It's likely a lot of lawyers told their

clients about the "outs" in these contracts, he said, but if they really wanted to get it done, they barreled ahead.

"The private equity firms don't do these deals lightly. There is not a good conspiracy theory about why they would sign up for these deals and not do them," he said.

Strine also averred it is "amazing" how little people talk about the obligations of the financing parties.

"There is a difference in incentives between the private equity firms and their

financing partners. We are dealing with a buy side that is divided between the equity part and the financing part and divided between the formalism of law and the economic reasons people are doing deals," he said.

The visiting scholar lecture was sponsored by The Delaware Counsel Group, a Wilmington-based law firm that advises nationally and internationally on Delaware corporate and alternative entity law. This was the fourth year of the lecture. •

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