THE FAILURE OF PRIVATE EQUITY

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I. INTRODUCTION

The fall of 2007 heralded a tumultuous time in the U.S. capital markets. The implosion of the subprime mortgage market disrupted the economy and caused the credit markets to dry up and become increasingly illiquid.[1] Almost overnight, credit became both more expensive and more difficult to obtain as financial institutions became unwilling to extend financing.[2] The credit securitization market was particularly affected, leaving many financial institutions with pending and existing loans that they could only securitize and sell, if at all, at a large loss.[3] Faced with these potentially large losses, financial institutions began to balk at funding preagreed 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—acquisitions which had been agreed to in more stable times.[5] The private equity firms'

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*, BUS. WK., Sept. 3, 2007, at 30; Phil Izzo, *Economists in Poll Expect Credit Turmoil to Continue*, WALL ST. J., Nov. 15, 2007, at A4.

2. *See* Antony Currie & Dwight Cass, *Ominous Crunching*, WALL ST. J., Nov. 2, 2007, at C14; Eric Dash, *Debt Market Looks to Fed to Ease Fear*, N.Y. TIMES, Sept. 18, 2007, at C1.

3. Leveraged loans 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 II.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. When the CLO market closed in August 2007, it hampered the ability of these financial institutions to extend new loans. In addition, the closing of the securitization and CLO market left these financial institutions with extended loans that either could not be sold or could only be sold at a loss. Thus, not only did financial institutions stop lending, but they were also economically incentivized not to fund previously agreed-to loans, since the loans were now unsaleable except at a steep loss. *See* Floyd Norris, *Sickly Credit Markets Heal a Little as Leveraged Loans Rebound*, N.Y. TIMES, Oct. 6, 2007, at C3.

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* Katherine A. Cattanach, Mary Frances Kelley & Gail Marmorstein Sweeney, *Hidden Treasure: A Look into Private Equity's History, Future, and Lure*, J. PRIVATE PORTFOLIO MGMT., Summer 1999, at 27.

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 Buyers' Remorse*, MERGERS & ACQUISITIONS, Oct. 2007, at 40.

reevaluations were often unkind. Throughout the fall and into 2008, private equity firms repeatedly attempted to terminate their contractual obligations to acquire companies.[6]

Many private equity firms successfully relied on the negotiated language in their contracts either to terminate their pending acquisitions or to agree on a settlement with the same effect.[7] In many instances, litigation ensued before such dispositions. The litigation surrounding these terminations and the heightened scrutiny directed on the terms of private equity agreements opened a revealing window into the practices of parties and attorneys who had negotiated and structured private equity transactions. Under the public glare, many apparent contractual drafting errors in the private equity structure came to light. Moreover, 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 that permitted private equity firms to terminate an acquisition for any reason by paying a flat fee of approximately 3 percent 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 examines the structure of these private equity transactions and the role of lawyers, particularly those representing acquirees, in their negotiation and documentation. It seeks to understand the forces driving the evolution of the private equity structure, the rationale for the structure, and its contractual terms. I look to answer these questions through an examination of litigation transcripts, interviews with industry participants, information from a database of 193 private equity contracts, and other

6. *See infra* Part III.

7. *See infra* Part III. For a list of selected failed or renegotiated private equity transactions during this time period, see *infra* app.

8. *See infra* Part V.D.

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

10. The author participated on one such panel entitled "Who is to Blame?" before the Mergers, Acquisitions and Split-Ups class taught by Robert Clark and Vice Chancellor Leo Strine at Harvard Law School. *See generally* Audio tape: "Who is to Blame?" Panel, held at Harvard Law School (Nov. 11, 2008) (on file with author) [hereinafter Harvard Talk].

public records.[11]

This Article ultimately seeks to explain and understand the reasons for the collapse of these private equity deals. The principal failure of the private equity industry in the period leading up to August 2007 was the failure of financial institutions to properly price their loans and financial instruments.[12] This allowed private equity firms to acquire a vast portfolio of companies at low interest rates and flexible credit terms, with minimal money invested.[13] This pricing failure is part of a broader credit failure that has caused the current financial crisis.

The focus of this Article is not on that aspect of the private equity industry, but rather it is on the serial collapse of private equity acquisitions after August 2007. These deals failed because private equity firms and financial institutions attempted to terminate contractual commitments made in better economic times. Given the new economic environment and loss incentives, these private equity firms and financial institutions leveraged any advantageous contractual clause or ambiguity to escape their contractual obligations. It was in these extraordinary measures to escape their commitments that the so-called "flaws" in the private equity structure became apparent.

This Article is about this alleged failure of private equity: whether these flaws existed and, if so, why lawyers—particularly lawyers for acquirees—negotiated them and allowed them to exist. Here, the claimed errors and failures in the private equity structure that this Article highlights and seeks to examine and explain are of a two-fold variety: (1) first-order mistakes such as contractual drafting errors made by private equity lawyers, and (2) second-order errors resulting from lawyers negotiating a fundamentally flawed private equity structure.

The first-order failures were rather apparent in the disputes of 2007 and 2008, but the existence of second-order failures is uncertain. Here, some have asserted that the structure of private equity itself was not fundamentally flawed, but rather it was a result of arms-length

11. All citations to MergerMetrics Database involve searches for private equity acquisitions of public companies with transaction values greater than $100 million for which a transaction document was available.

12. Jane Gladstone-Wheeler, Senior Managing Dir., Evercore Partners, Speech at the Penn State Dickinson Sch. of Law: Fifth Annual Institute on Corporate Securities and Related Aspects of Mergers and Acquisitions (Nov. 25, 2008).

13. Andrew Ross Sorkin, *The Money Binge*, N.Y. TIMES, Apr. 4, 2007, at H1.

bargaining.[14] In other words, many lawyers have argued that, until August 2007, the structure of private equity was simply the best deal available. This only partly explains the rationale for the structure of private equity, however, because notions of transactional "optimality" in the private equity structure are relative. The structure of private equity results from "good enough" structuring decisions made by transactional attorneys who are disincentivized to innovate.[15] I find that the private equity attorney, as a transaction-cost engineer, structures the private equity contract by heeding contractual terms and law, contractually created forces, and nonlegal factors such as reputation.[16] The attorney measures the weight of each of these and adjusts contractual terms and transaction structure in response. These extracontractual forces, however, incentivize private equity lawyers to avoid innovating. Change in the private equity structure is thus intermittent, caused by exogenous forces, and results in piecemeal revisions premised on the preexisting structure. The structure of private equity cannot be characterized as an efficient one due to the structure's strong path dependency.[17]

Moreover, the private equity legal universe is small and self-contained. From January 1, 2004, through August 1, 2007, the same twenty-two law firms represented either an acquiree or a private equity acquirer in 91 percent of all private equity transactions.[18] Given that these law firms repeatedly represent private equity firms but only represent acquirees on a one-off basis, these law firms may not be fully incentivized to negotiate innovative, beneficial provisions for acquirees. While this agency cost may not have been the determining factor in the failure of the private equity structure, it likely contributed to the forces working against

14. *See* Vipal Monga, *Turning the Tide*, THEDEAL.COM, Aug. 29, 2008, http://www.thedeal.com/newsweekly/features/turning-the-tide.php (quoting one practitioner calling reverse termination fees a "basic price of doing business").

15. The proposition that forces push lawyers toward "good enough" decisions was first brought to my attention in the scholarship of Claire 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, 1305 (2001) (examining the forces that 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").

16. 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 Ronald Gilson. *See* Ronald J. Gilson, *Value Creation by Business Lawyers: Legal Skills and Asset Pricing*, 94 YALE L.J. 239, 243 (1984).

17. For a discussion of the meaning of path dependency, see *infra* notes 239–40 and accompanying text.

18. *See infra* note 279 and accompanying table.

innovation in the private equity structure.[19] Reliance on extracontractual legal forces additionally allowed attorneys to hide this possible bias.

The findings of this Article contribute to a larger debate about what business lawyers actually do and how they add value to transactions. This debate is framed by Ronald Gilson's seminal 1984 article, *Value Creation by Business Lawyers: Legal Skills and Asset Pricing*.[20] In that article, Gilson postulated that business lawyers create value in transactions, net of legal fees, by negotiating "a transactional structure which reduces transaction costs and therefore results in more accurate asset pricing."[21] Since that time, little has been written on this issue.[22] This story of private equity and its attorneys is an attempt to add to this literature by describing the good and the bad of transactional lawyering, and the agency and other costs that are associated with it. Lawyers may add value as Gilson theorizes, but they may also increase transaction costs and fail to realize their full value potential.

In this regard, this Article is a wider case study of how business lawyers negotiate contracts, how contracts function in a particular industry, how path dependency can exist even in sophisticated environments, and how extralegal norms and conventions can fail. Here, this Article aims to fill an increasingly noted gap in the contracts and "dealmaking" literature.[23] There has been much theoretical discourse but little research into how business clients and their attorneys negotiate and agree to complex contracts in either continuing or discrete relationships.[24]

In looking at this question, I find that the private equity bargain is a rich, textured environment. The terms of the contractual relationships

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19. *See* discussion *infra* Part V.C.

20. *See* Gilson, *supra* note 16, at 243–44.

21. *Id.* at 255.

22. For other accounts, see Steven L. Schwarcz, *To Make or to Buy: In-House Lawyering and Value Creation*, 33 J. CORP. L. 497 (2008); Jeff Lipshaw, *The Mythology of Value Creation: Lawyers, Neckties, and Balinese Cock-Fighting*, CONGLOMERATE, Oct. 23, 2008, http://www.theconglomerate.org/2008/10/the-mythology-o.html. *Cf.* Rachel S. Arnow-Richman, *Employment as Transaction* (Univ. of Denver Sturm Coll. of Law Legal Research Paper Series, Working Paper No. 08-21, 2008), *available at* http://ssrn.com/abstract=1154082 (asserting that transactional skills and the role of the transactional lawyer are neglected parts of the law school curriculum).

23. *See* D. Gordon Smith & Brayden G. King, *Contracts as Organizations*, 51 ARIZ. L. REV. (forthcoming 2009) (manuscript at 2–3, *available at* http://ssrn.com/abstract=969816). *See also* Stewart Macaulay, *Contracts, New Legal Realism, and Improving the Navigation of the Yellow Submarine*, 80 TUL. L. REV. 1161, 1191 (2006) (noting that there has been little academic study of how business people draft contracts in the shadow of legal rules).

24. *See* Smith & King, *supra* note 23, at 20–24 (surveying the limited number of contract studies).

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 private sphere, parties to private equity contracts and their lawyers utilize norms, conventions, and outside constraints to fill contractual gaps, to override explicit contractual terms, and to 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 often differs from the judicial interpretations of the terms they utilize.[25]

The private equity contract, thus, 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.[26] Rather, the contract functions as a fulcrum for further private bonding, interpretation, negotiation, and agreement after execution of the acquisition agreement.[27]

In the private equity structure, however, contract terms do play an important, flexible role throughout the relationship. Flipping the iceberg on its head, the contract is not the endpoint; rather, it is the foundation and starting point for an understanding among the parties. The contract matters

25. *Cf.* Lawrence M. Solan, *Contract as Agreement*, 83 NOTRE DAME L. REV. 353, 401–05 (2007) (highlighting courts' focus on common ordinary meaning despite the subjective intent of the parties).

26. *See* Claire A. Hill, *Bargaining in the Shadow of the Lawsuit: A Social Norms Theory of Incomplete Contracts*, 34 DEL. J. CORP. L. (forthcoming Apr. 2009) (manuscript at 18–19, *available at* http://ssrn.com/abstract=1288689). For further discussion, see *infra* notes 221–26 and accompanying text.

27. *See* Sergio G. Lazzarini, Gary J. Miller & Todd R. Zenger, *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."). The findings of this Article's study differ from 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. *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) ("[T]he 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, 899–903 (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.

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.[28] It is also a world that Lisa Bernstein and Stewart Macaulay, who have written extensively on social norms and their role in establishing extralegal business relationships, would not find surprising.[29]

Part II of this Article examines the historical evolution of the private equity contract and structure. Part III details the very public failure of these contracts. Part IV focuses on the structure of private equity and its alleged failures as well as the negotiation process for these transactions and the drafting errors made by lawyers documenting this structure. Part V details the path dependency of the private equity structure and the role of attorneys, particularly those for acquirees, in perpetuating the structure. Part VI concludes with a discussion of the response of market participants to the failures of private equity and its implication for the future structure of these transactions.

II. THE STRUCTURE OF PRIVATE EQUITY

The structure of private equity is largely a product of its unique financing. Private equity firms pervasively utilize substantial leverage to purchase public and private corporations. The firms typically borrow 60

28. 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 implications for the neoformalists and those who advocate for less "law" in judicial interpretation of contracts. *See* Eric A. Posner, *A Theory of Contract Law Under Conditions of Radical Judicial Error*, 94 NW. U. L. REV. 749, 753–54 (2000); Eric A. Posner, *Law, Economics, and Inefficient Norms*, 144 U. PA. L. REV. 1697, 1697–98 (1996); Robert E. Scott, *The Case for Formalism in Relational Contract*, 94 NW. U. L. REV. 847, 847–48 (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 277, 277 (Peter Newman ed., 1998). This case study of private equity lends support to the neoformalist view. *See* discussion *infra* note 303.

29. *See* Lisa Bernstein, *Opting Out of the Legal System: Extralegal Contractual Relations in the Diamond Industry*, 21 J. LEGAL STUD. 115, 117 (1992); Lisa Bernstein, *Private Commercial Law in the Cotton Industry: Creating Cooperation Through Rules, Norms, and Institutions*, 99 MICH. L. REV. 1724, 1724–25 (2001); Stewart Macaulay, *Non-Contractual Relations in Business: A Preliminary Study*, 28 AM. SOC. REV. 55, 65–67 (1963). My observations are echoed in none other than Karl Llewellyn's work from almost eighty years ago. *See generally* Karl N. Llewellyn, *What Price Contract?—An Essay in Perspective*, 40 YALE L.J. 704, 740–41 (1931) (discussing the importance of informal understandings to commercial arrangements).

percent to 80 percent of the required purchase price and obtain the remaining necessary capital from precommitted investors who provide equity for this purpose.[30] In order to enhance returns and increase the number of purchased companies, private equity firms seek to place as much debt and as little equity as feasible onto the acquisition capital structure.[31] Private equity is therefore significantly dependent on the nature of debt financing and the availability of credit. If credit is more freely available at lower interest rates, this permits private equity firms to borrow more money and make increased acquisitions at higher prices. Because of this, the structure of private equity has evolved over the years, driven in large measure by the type and availability of financing.

A. THE ORIGINS OF THE PRIVATE EQUITY STRUCTURE

The foundation of today's private equity structure was laid in the 1970s and 1980s.[32] It began in 1976 when Jerome Kohlberg, Henry Kravis, and George Roberts created the first true private equity firm, Kohlberg, Kravis & Roberts Co. ("KKR").[33] The trio at KKR raised the industry's first equity fund in 1978.[34] This provided a prearranged source of committed equity capital. At this time, however, debt for acquisitions was still raised on an ad hoc basis and was largely limited to secured credit financing from bank lenders.[35] If private equity was to grow, a steady source of debt financing would be required in order to permit a larger

30. For example, when private equity funds affiliated with Cerberus Capital Management purchased 80.1 percent of Chrysler LLC, those funds had approximately one hundred coinvestors purchase part of this interest. *See* Louise Story, *Chrysler's Friends in High Places*, N.Y. TIMES, Dec. 6, 2008, at B1.

31. 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 they 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* Robert P. Bartlett III, *Taking Finance Seriously: How Debt Financing Distorts Bidding Outcomes in Corporate Takeovers*, 76 FORDHAM L. REV. 1975, 1981–87 (2008); Ronald J. Gilson & Charles K. Whitehead, Essay, *Deconstructing Equity: Public Ownership, Agency Costs, and Complete Capital Markets*, 108 COLUM. L. REV. 231, 231–40 (2008).

32. *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 & JOHN HELYAR, BARBARIANS AT THE GATE 133–36 (1990).

33. *See* Allen Kaufman & Ernest J. Englander, *Kohlberg Kravis Roberts & Co. and the Restructuring of American Capitalism*, 67 BUS. HIST. REV. 52, 67–68 (1993).

34. *Id.* at 71. *See also* GEORGE ANDERS, MERCHANTS OF DEBT: KKR AND THE MORTGAGING OF AMERICAN BUSINESS 46 (1992).

35. *See* Brian Cheffins & John Armour, *The Eclipse of Private Equity*, 33 DEL. J. CORP. L. 1, 18 (2008).

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 ("Drexel"). 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.[36] This debt was often referred to as junk because it was either unrated or rated below investment grade, and was subordinated to other senior, more highly rated debt.[37] Historically, high-yield debt was shunned by investors and utilized by small issuers who had fewer financing choices.[38] Milken had studied this market and found that investors in this debt had historically realized extraordinary returns.[39] He popularized this finding and soon convinced many institutional and other investors to purchase the high-yield debt offerings that Drexel underwrote.[40] Milken needed an even larger supply of issuers of these securities to fulfill the demand he largely had created.

In private equity, Milken found a large source: in the mid-1980s private equity acquisitions became one of the principal issuers of high-yield securities.[41] Private equity firms during this time used traditional senior secured loans together with high-yield and other debt-type securities to increase the debt level on individual acquisitions.[42] The additional funds provided by this high-yield financing allowed private equity firms to make larger and more frequent company purchases.[43] It would be the nature of this debt 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 and the early 1990s can be diagramed as follows:

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36. DANIEL FISCHEL, PAYBACK 16–17 (1995).

37. *See* PATRICK A. GAUGHAN, MERGERS, ACQUISITIONS, AND CORPORATE RESTRUCTURINGS 330–31 (3d ed. 2002).

38. GLENN YAGO, JUNK BONDS 20–26 (1991).

39. *See* CONNIE BRUCK, THE PREDATOR'S BALL 11 (1988).

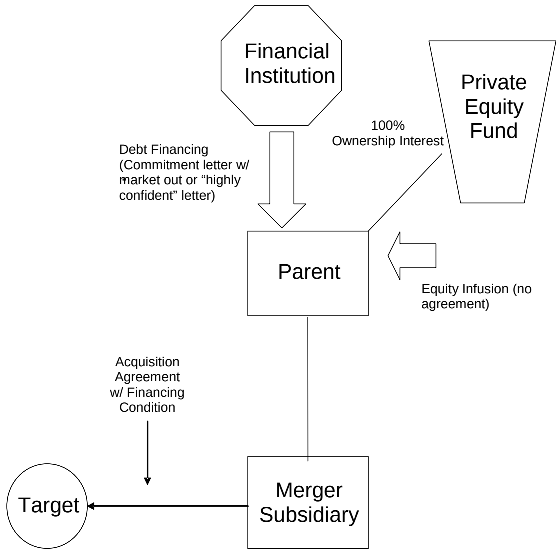
40. *Id.*

41. *See* YAGO, *supra* note 38, at 26–27; Cheffins & Armour, *supra* note 35, at 19.

42. BURROUGH & HELYAR, *supra* note 32, at 140–41.

43. *See* Kaufman & Englander, *supra* note 33, at 76–79.

FIGURE 1. PRIVATE EQUITY STRUCTURE: 1980S TO EARLY 1990S[44]



In the above structure, the private equity buyout was effected by thinly capitalized shell subsidiaries—Parent and Merger Subsidiary in the above diagram—set up specifically for this purpose by the private equity firm.[45] 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.[46] Since the shells had no real assets, the company to be acquired—Target 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 a commercial bank—Financial Institution in the above diagram.[47] 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 related financing offering.[48]

44. *See* David J. Sorkin & Eric M. Swedenburg, *Recent U.S. Deals Depart from Traditional Financing*, INT'L FIN. L. REV., Jan. 2006 (Supp. Guide to Private Equity and Venture Capital), at 103.

45. The fund uses separate shell subsidiaries to effect the acquisition in order to limit its liability, among other reasons.

46. Sorkin & Swedenburg, *supra* note 44, at 103–04.

47. *See* Mario L. Baeza et al., *Recent Developments in Leveraged Buyouts*, *in* ACQUISITIONS AND MERGERS 1989, at 653, 714–17 (PLI Corp. Law & Practice, Course Handbook Series No. B4-6883, 1989).

48. *See* BRUCK, *supra* note 39, at 45–46.

Importantly, the debt commitment letter was not a binding arrangement to provide funds; rather, it was an agreement to negotiate definitive financing arrangements on the terms set forth in the commitment letter.[49] In addition, the commitment letter was executed at the time the acquisition agreement was executed.[50] The final credit documentation was not signed until after the transaction was announced.[51] The banks would then extend any loans and attempt to sell the high-yield debt to finance the acquisition at the time of the completion of the transaction.[52]

Because there was a 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 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 than expected when the agreements were first signed, thereby incurring a loss. In extreme circumstances, they might be entirely unable to sell the debt.

To address this issue, the banks typically negotiated commitment letters that contained a "market out" clause, which permitted the banks to terminate their financing obligations if market conditions deteriorated or otherwise impeded placement or incurrence of the debt.[53] 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.[54] These letters were pioneered by Drexel in financings where the success of the debt issuance was too uncertain to provide any firm written commitments.[55] The financing banks would instead opine that they were highly confident that the debt could be raised in the markets but provided no contractual agreement to do so.[56]

In either case, though, the private equity fund itself was not liable if

49. *See* Baeza et al., *supra* note 47, at 717.

50. *Id.*

51. *See* Lawrence Lederman, *Representing a Public Company in a Leveraged Buyout Transaction*, *in* HOSTILE BATTLES FOR CORPORATE CONTROL 1988: THE NEW MARKET ENVIRONMENT 107, 175–76 (PLI Corp. Law & Practice, Course Handbook Series No. B4-6821, 1988).

52. *See* BURROUGH & HELYAR, *supra* note 32, at 506.

53. Sorkin & Swedenburg, *supra* note 44, at 104.

54. BRUCE WASSERSTEIN, BIG DEAL: 2000 AND BEYOND 686–87 (2000); Sorkin & Swedenburg, *supra* note 44, at 103.

55. *See* BRUCK, *supra* note 39, at 166.

56. WASSERSTEIN, *supra* note 54, at 686–87.

the transaction failed to close. Due to the uncertainty of debt financing, private equity firms refused to commit themselves to fund the acquisition entirely if debt financing failed.[57] Acquirees typically agreed to this demand.[58] Since private equity firms had no contractual obligation to fund the acquisition, this effectively provided private equity firms with an ability to exit from the buyout any time before consummation of the acquisition for any reason, even beyond failure of the debt financing. The only real legal constraint on the private equity firm's ability to do so was a possible veil-piercing argument by Target: the shell subsidiaries were dominated by the private equity fund such that their separate limited liability should be disregarded by the courts.[59] 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.[60]

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 funds.[61] 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

57. The equity capital was the share ownership stake, and together with debt financing, comprised the funds used to purchase the acquiree.

58. *See* Sorkin & Swedenburg, *supra* note 44, at 103 (noting that the use of equity commitment letters did not occur until the 1990s).

59. I was unable to ascertain, however, whether this type of claim was ever made.

60. *See* Sorkin & Swedenburg, *supra* note 44, at 103–04.

61. *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 fundraising after the transaction announcement. *See, e.g.*, Henry R. Kravis, Keynote Speech at the *Private Equity Analyst* Conference (Sept. 22, 2004) (transcript available at http://files.shareholder.com/downloads/KKR/514442416x0x239233/26c3a702-e4c7-47b3-b87b-d88ad11a64de/PrivateEquityAnalyst.pdf). An equity commitment letter was inappropriate at that time because any equity had yet to be committed, and the parties who would commit the equity were still unknown. In contrast, by the 1990s, private equity firms had dedicated equity capital available in preraised funds.

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 with the necessary equity investment for the acquisition.

During this time period, the terms of debt commitment letters also shifted to include bridge financing.[62] Bridge financing is interim financing put in place at acquisition completion to "bridge" the financing gap until the placement of any permanent debt financing.[63] The addition of bridge financing thus provided increased certainty to the acquiree that the transaction would be completed if the offering of any permanent debt was delayed.

The structure of private equity deals further evolved in the new millennium. A significant shift in transaction structure was triggered by the March 2005 $11.3 billion buyout of SunGard Data Systems, Inc. by a private equity consortium.[64] This was the largest leveraged buyout since the buyout of RJR Nabisco by KKR in 1989.[65] The structure of the SunGard transaction is presented in Figure 2.

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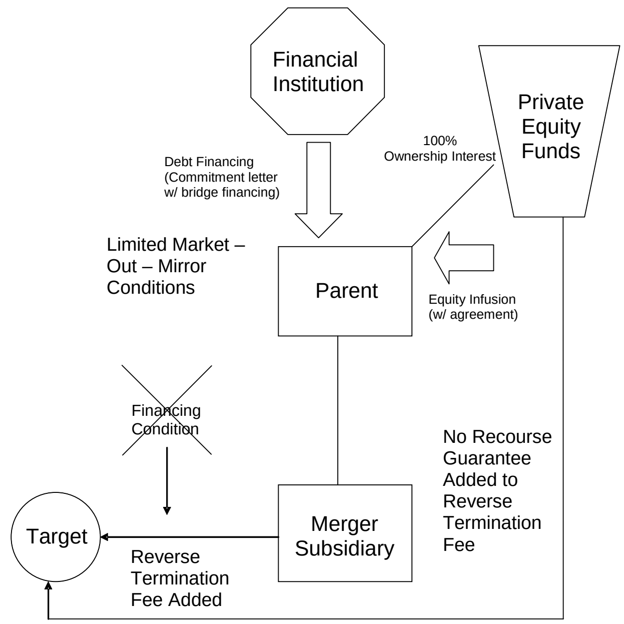
62. *See A New Generation of Bridge Lending*, MERGERS & ACQUISITIONS, Sept.–Oct. 1994, at 6; *Bridge Loans Make a Comeback*, CORP. GROWTH REP. WKLY., Aug. 14, 1995, at 7987, *available at* http://findarticles.com/p/articles/mi_qa3653/is_199508/ai_n8718959.

63. Tuck Sch. of Bus. at Dartmouth, Ctr. for Private Equity & Entrepreneurship, Private Equity Glossary, http://mba.tuck.dartmouth.edu/pecenter/resources/glossary.html (last visited Mar. 20, 2009).

64. *See* Andrew Ross Sorkin, *Private Investment Firms to Pay $11.3 Billion for SunGard Data*, N.Y. TIMES, Mar. 28, 2005, at A15. *See also* Martin Sikora, *LBO Funds Offer Incentives to Drive High-Priced Deals*, MERGERS & ACQUISITIONS, Sept. 2005, at 18 (describing the SunGard transaction as "a major shift from traditional leveraged dealmaking").

65. Sorkin, *supra* note 64.

FIGURE 2. SUNGARD STRUCTURE CIRCA 2005[66]



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.[67] The debt portion of the transaction was agreed to through a commitment letter by five investment banks and included a bridge financing facility.[68] SunGard also negotiated the removal of the financing condition from the acquisition agreement among SunGard and the shell subsidiaries controlled by the private equity consortium. In addition to negotiating the deletion of a financing condition, SunGard was also able to obtain a debt commitment letter that had conditions reciprocal to those in the acquisition agreement. In other words, if the conditions to the acquisition agreement were satisfied, the debt commitment letter conditions would be as well. By better aligning the terms of the debt commitment letter and the main acquisition agreement, the financing for the transaction was more certain to occur if the conditions in the main agreement were fulfilled. Finally, the SunGard debt commitment letter

66. This figure was prepared from information contained in SunGard Data Sys., Inc., Definitive Proxy Statement (Schedule 14A), at 49–54 (June 27, 2005) [hereinafter SunGard Proxy Statement].

67. *Id.* at 49–50.

68. *Id.* at 50–53.

contained a limited "market out" and "lender out" condition.[69] The result was a transaction structure more favorable to the acquiree because completion was contractually more certain.[70] Importantly, though, by agreeing to a more certain debt commitment letter and providing bridge financing, the banks now took on the risk of market deterioration between the time of signing and closing. If the value of the debt declined during this time period, the banks would suffer the loss. This appeared to be a rational decision in 2005—the days of easy credit—but it would be a decision that would savagely haunt these financial institutions.

In exchange for agreeing to the removal of the financing condition in the main acquisition agreement, SunGard also agreed to a $300 million cap on the private equity consortium's maximum liability for breach of the acquisition agreement.[71] In other words, if the shell was unable to complete the buyout because, for example, the financing arrangements failed or the agreement was intentionally breached, then the private equity fund's only liability was a fee of $300 million to SunGard as compensation. The fee was called a reverse termination fee because it was patterned on termination fees that acquirees typically agreed to pay acquirers in acquisition agreements if the acquiree subsequently accepted a higher offer from another bidder. The reverse termination fee in the SunGard transaction approximated 3 percent of the transaction value and equaled the termination fee.[72] And, since the shells were still empty corporations without substantial funds, the private equity funds issued a guarantee for the payment.[73] Finally, the guarantee contained no-recourse language, which purported to limit any veil-piercing argument by SunGard against the private equity firms.

This type of structure had been utilized in other transactions, but not in private equity deals.[74] The SunGard structure appears to be the first private equity transaction to employ such architecture.[75] After SunGard, the

69. 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." Sorkin & Swedenburg, *supra* note 44, at 104.

70. *See infra* notes 192–93 and accompanying text.

71. *See* SunGard Proxy Statement, *supra* note 66, at 91.

72. *Id.* at 90–91.

73. *Id.* at 54.

74. It appears that the structure was first utilized in acquisitions of real estate investment trusts, such as the buyouts of Extended Stay America and Wyndham International. *See* Extended Stay Am., Inc., Agreement and Plan of Merger (Form 8-K, Exhibit 99.1), §§ 8.03, 9.08 (Mar. 8, 2004); Wyndham Int'l, Inc., Agreement and Plan of Merger (Form 8-K, Exhibit 2.1), § 8.13 (June 15, 2005).

75. E-mail from Anonymous Hedge Fund Managing Director to Steven M. Davidoff (Sept. 11, 2008, 14:56 EST) (on file with author).

structure quickly took hold in private equity transactions. I discuss the reasons for its quick adoption in Part V, but the following figure sets forth my own calculations as to the percentage of private equity acquisitions utilizing a reverse termination fee structure from 2005 through 2008:

FIGURE 3. PRIVATE EQUITY STRUCTURE (2005–2008)[76]

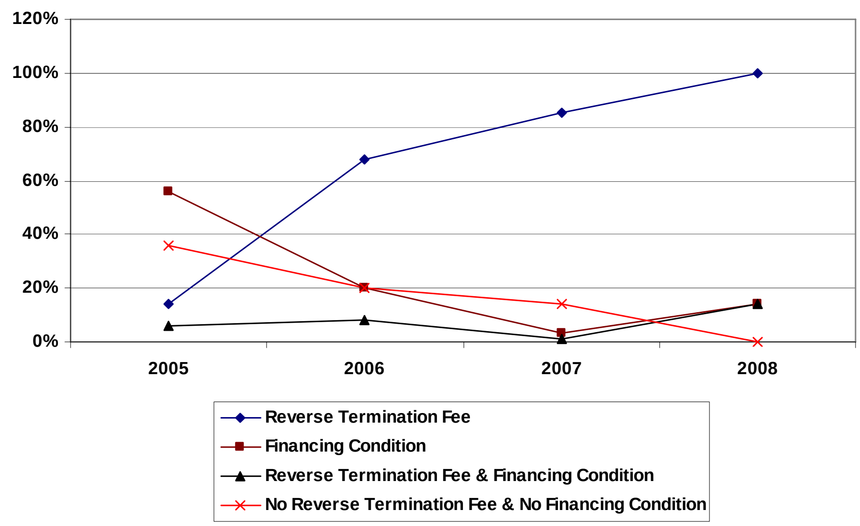


Figure 3 shows a rapid shift in practice, as the use of financing conditions in acquisition agreements dropped in inverse proportion to the utilization of the reverse termination fee structure. The reverse termination fee became the norm in private equity acquisitions, but the structure sometimes varied depending on the parties' agreement. For example, in the 2005 private equity buyout of Neiman Marcus, the private equity acquirers agreed to a two-tiered termination fee.[77] A lower fee would be paid if the private equity shell subsidiaries breached the agreement and failed to complete the transaction due to the failure to obtain financing. A significantly higher fee, phrased as a cap on the private equity consortium's

76. Author calculations from MergerMetrics Database. Note that the 2008 figures are only through May 1, 2008. Information is only for announced public private equity deals greater than $100 million in value and for which a transaction document was available or a tender offer was launched. In addition, this data includes reverse termination fees paid for other purposes, such as in the case of a failure to obtain regulatory approvals.

77. Neiman Marcus Group, Inc., Definitive Proxy Statement (Schedule 14A), at 67–68 (July 18, 2005). The Neiman Marcus transaction was also notable for completely eliminating the market-out clause in debt commitment letters, a change to the structure that would persist. *See id.* at 38–39.

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 buyouts, such as that of Penn National Gaming where, under the terms of the contract, the acquiree could force the private equity shell subsidiaries to specifically perform and enforce the debt and equity commitment letters to complete the transaction.[78] If for some reason the debt or equity financing 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 allowed the private equity firm to exit a transaction simply by paying the reverse termination fee. The third variation 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 firms 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.

The reverse termination fee structure and its variations had rapidly become the blueprints of private equity heading into summer of 2007. I will discuss the reasons for this shift in structure in Part V, but before I do, it is first necessary to detail the events of fall 2007 and onward.

III. THE FAILURE OF PRIVATE EQUITY

The structure of private equity appeared to have achieved a new equilibrium after a significant transformatory period from 2005 to 2007. Lawyers in private equity transactions had leveraged the increased willingness of lenders to provide more flexible terms to renegotiate the boilerplate of private equity. However, the credit crisis that ensued in the summer of 2007, and the subsequent events over the course of the following year, exposed flaws in this structure. Part III discusses the events of the summer of 2007 and afterwards. These events would be the mother of all shocks to the structure of private equity. The ensuing events revealed not only the inherent problems with the private equity structure, but also opened up a further window into the manner of negotiating these agreements and their evolution.[79]

78. Penn Nat'l Gaming, Inc., Definitive Proxy Statement (Schedule 14A), at 90–91 (Nov. 7, 2007).

79. *See* Private Equity's Option to Buy, M&A Law Prof Blog, http://lawprofessors.typepad.com/

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 Accredited Home Lenders Holding Co. and Radian Group, Inc.—attempted to terminate their acquisition agreements.[80] To do so, each of these acquirers invoked a material adverse change ("MAC") clause in its agreement.[81] A MAC clause is a provision in an acquisition agreement that 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.[82] The invocation of MAC clauses in these two instances was a sign that market and economic turbulence was beginning to affect takeover transactions. These first two MAC claims, however, were confined to the industries most directly affected by the summer subprime mortgage crisis—both of the acquiree companies, Accredited Home Lenders and Radian, were in the subprime lending business. Moreover, both of these transactions utilized a non-private-equity acquisition structure—that is, each transaction was structured in the manner of the traditional strategic acquisition and did not have a financing-out or reverse termination fee provision.[83]

But as August progressed, stock market volatility increased and the credit markets became increasingly illiquid. Public attention turned to the greater than $250 billion in pending private equity transactions.[84] 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 *New York Times* on August 21, 2007 and was entitled *Can Private Equity Firms Get*

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mergers/2007/08/private-equitys.html (Aug. 16, 2007) [hereinafter Option to Buy].

80. *See* Paul Gores, *MGIC Sues Merger Partner for Data; Subprime Crisis Prompts Mortgage Insurer's Lawsuit*, MILWAUKEE J. SENTINEL, Aug. 22, 2007, at D1; Lingling Wei & Kevin Kingsbury, *Accredited Home Sues Lone Star to Save Deal*, WALL ST. J., Aug. 14, 2007, at C5.

81. *See* STEVEN M. DAVIDOFF, GODS AT WAR: SHOTGUN TAKEOVERS, GOVERNMENT BY DEAL, AND THE PRIVATE EQUITY IMPLOSION (forthcoming 2009) (manuscript at 56–59, on file with author).

82. Steven M. Davidoff & Kristen Baiardi, *Accredited Home Lenders v. Lone Star Funds: A MAC Case Study* 13–17 (Wayne State Univ. Law Sch. Legal Studies Research Paper Series, Research Paper No. 08-16, 2008), *available at* http://ssrn.com/abstract=1092115.

83. *See* DAVIDOFF, *supra* note 81 (manuscript at 66). For further discussion of the difference between the structure of strategic and private equity transactions, see *infra* notes 203–06 and accompanying text.

84. Jenny Anderson, *20/20 Hindsight Through What Were Once Rose-Colored Glasses*, N.Y. TIMES, Aug. 31, 2007, at C6.

Out of Buyouts?[85] The article highlighted the reverse termination fee structure now commonplace 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.[86]

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 that had been agreed to before the summer credit crisis. These transactions involved the buyouts of Acxiom Corp. and Harman International Industries, Inc. The acquirers, however, 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.[87]

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 an acquirer to invoke a MAC.[88] 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.[89] If their MAC claim failed, the maximum liability of the private equity funds was capped at the reverse termination fee.[90] The assertion of a MAC in combination with a reverse termination fee provision thus provided a

85. Andrew Ross Sorkin, *Can Private Equity Firms Get Out of Buyouts?*, N.Y. TIMES, Aug. 21, 2007, at C1. *See also* Option to Buy, *supra* note 79 (discussing how termination clauses allow companies to terminate deals by paying a predetermined fee).

86. Sorkin, *supra* note 85.

87. *See* Dennis K. Berman, *Acxiom's Suitors May Drop Offer*, WALL ST. J., Oct. 1, 2007, at A2; Michael J. de la Merced, *Wary Buyers May Scuttle Two Deals*, N.Y. TIMES, Sept. 22, 2007, at C1. For more information on these transactions, see generally Paul S. Bird & Jonathan E. Levitsky, *Deals Redefined*, DAILY DEAL, Dec. 19, 2007.

88. *See* Andrew Ross Sorkin, *If Buyout Firms Are So Smart, Why Are They So Wrong?*, N.Y. TIMES, Nov. 18, 2007, § 3, at 8; Steven M. Davidoff, *The Big MAC*, DEALBOOK, N.Y. TIMES, Mar. 10, 2008, http://dealbook.blogs.nytimes.com/2008/03/10/the-big-mac.

89. *See* Acxiom Corp., Agreement and Plan of Merger (Form 8-K, Exhibit 2.1), § 8.3 (May 16, 2007) [hereinafter Acxiom Merger Agreement]; Harman Int'l Indus., Inc., Agreement and Plan of Merger (Form 8-K, Exhibit 2.1), §§ 7.01–.02 (Apr. 26, 2007) [hereinafter Harman Merger Agreement]. *See also* Kelly Holman, *Big MAC Attack? "Material Adverse Change" Clause Getting More Attention*, INVESTMENT DEALERS' DIG., Oct. 1, 2007 (discussing MAC clauses generally).

90. *See* Acxiom Merger Agreement, *supra* note 89, § 9.8; Harman Merger Agreement, *supra* note 89, § 7.02.

private equity firm with negotiating leverage by setting its maximum liability in any settlement or litigation.[91]

Both of these MAC claims were ultimately settled through agreements among the parties that terminated the acquisition agreement.[92] The legitimacy of these MAC claims was revealed by the amounts the private equity firms ultimately paid to the acquirees to terminate the transactions. In each case, the payment was close to the reverse termination fee amount.[93] Thus, in the early fall of 2007, private equity firms could be seen as attempting to avoid reputational tarnish by asserting MAC claims to avoid 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 settlements 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. In most of these cases, failed transactions left the acquirees' stock prices trading significantly below their prices prior to the announcement of the acquisition agreement.[94]

Finally, during this time period there was a third MAC dispute between SLM Corp. and its consortium buyers, private equity firm J.C. Flowers, Bank of America, and J.P. Morgan Chase.[95] This dispute concerned whether passage of the College Cost Reduction and Access Act ("CCRAA") of 2007 by Congress had triggered a MAC against SLM.[96] Here, the kernel of the debate was over ambiguous language in the MAC

91. Interview with Jerry C. Jones, Gen. Counsel, Acxiom Corp. (Oct. 10, 2007).

92. *See* Kelly Holman, *Breaking Up Is (Less) Hard to Do: PIPE-Like Deal Resolves Harman Dispute*, INVESTMENT DEALERS' DIG., Oct. 29, 2007.

93. The Acxiom merger agreement provided for a two-tiered reverse termination fee: $66.75 million if the buyers breached the agreement in the case of a financing failure, and $111.25 million if the buyers breached the agreement for any other reason. By invoking the MAC clause, however, the private equity firm was able to force a settlement in an amount equal to 97.38 percent of the lower reverse termination fee. *See* Press Release, Acxiom Corp., Acxiom Release (Oct. 10, 2007), *available at* http:// www.acxiom.com/72451/Acxiom_Release; Interview with Jerry C. Jones, *supra* note 91. 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 acquisition agreement. *See* Press Release, Harmon Int'l Indus., Inc., KKR and GS Capital Partners to Invest in Harman International (Oct. 22, 2007), *available at* http://www.harman.com/press/financial_press.aspx?st=.

94. *See* Elizabeth Nowicki, Private Equity Deals of 2007: Lessons To Learn 5 (2008) (unpublished manuscript, on file with author) (listing the posttermination declines in stock prices of private equity acquirees in failed transactions).

95. *See* Dennis K. Berman, *Buyout Group Balks at Sallie Mae*, WALL ST. J., Sept. 27, 2007, at A3.

96. *See* Transcript of Scheduling Conference at 22–23, SLM Corp. v. J.C. Flowers II L.P., No. 3279-VCS (Del. Ch. Oct. 22, 2007), *available at* http://lawprofessors.typepad.com/mergers/files/ slm_delaware_chancery_transcript.pdf.

clause.[97] The language was unclear as to whether the passage of the CCRAA had caused a MAC to SLM.[98] The case was litigated in Delaware Chancery Court but settled before it could go to trial.[99] This would be the first of a number of private equity disputes where ambiguous drafting language would spur litigation.

B. THE FAILURE OF NORMS

In *Federalist Paper No. 15*, Alexander Hamilton observed that reputation is a "less active influence" constraining behavior when a nefarious deed is done by many.[100] 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 buyout 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, thus, an untrustworthy future acquirer. As the fall progressed, however, the reputational forces on private equity firms to complete buyouts became diluted as the credit markets remained illiquid and the number of terminated private equity deals increased.[101]

This dilution prominently evidenced itself on November 14, 2007, when the private equity fund controlled by Cerberus Capital Management, L.P. ("Cerberus") attempted to terminate its agreement to acquire United Rentals, Inc. ("URI").[102] Cerberus did not assert a MAC to justify its action. Rather, the shell subsidiaries who were controlled by Cerberus and who were the parties to the acquisition agreement simply invoked the reverse termination provision in the acquisition agreement.[103] Cerberus argued that this provision permitted it to terminate its obligations for any

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97. *See id.* at 22.

98. *See* SLM: The Legal Case (Redux), M&A Law Prof Blog, http://lawprofessors.typepad.com/mergers/2007/09/slm-the-legal-c.html (Sept. 27, 2007).

99. *See* Andrew Ross Sorkin & Michael J. de la Merced, *Sallie Mae Settles Suit over Buyout that Fizzled*, N.Y. TIMES, Jan. 28, 2008, at C1.

100. THE FEDERALIST NO. 15, at 72 (Alexander Hamilton) (Buccaneer Books 1992).

101. *See* Sorkin, *supra* note 88; Karen Donovan, *Private Equity: Breaking Up Is Not That Hard to Do*, PORTFOLIO.COM, Dec. 27, 2007, 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.").

102. *See* Press Release, United Rentals, Inc., United Rentals Says Cerberus Repudiates Merger Agreement, Cerberus Admits No Material Adverse Change Has Occurred (Nov. 14, 2007), *available at* http://www.ur.com/index.php/news/2007-11-14_1/?page=1.

103. *See* United Rentals, Inc., Letter from Steven F. Mayer, President, RAM Holdings, Inc., to Roger E. Schwed, General Counsel, United Rentals, Inc. (Form 8-K, Exhibit 99.2) (Nov. 14, 2007).

reason upon payment of a $100 million reverse termination fee.[104] 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 reputational loss.[105]

URI sued the Cerberus shell subsidiaries in Delaware Chancery Court challenging their attempt to terminate the agreement.[106] URI argued that the agreement provided that URI could require specific performance of the shell subsidiaries' obligations.[107] In other words, the parties' dispute focused on the type of reverse termination fee structure they had negotiated: the pure reverse termination fee or the specific performance structure. URI argued that this agreement provided for specific performance of the shell subsidiary entities' financing commitments.[108] Only if the financing then failed could the entities terminate the agreement.[109] The Cerberus shell subsidiaries argued that the same language of the agreement barred specific performance and that their only liability was for $100 million.[110] In other words, the parties were arguing that the same agreement specified two completely different termination mechanisms. Indeed, a review of the agreement found that it had two arguably conflicting termination clauses.[111]

The lawsuit was complicated by the fact that the acquisition agreement was governed by Delaware law and contained a Delaware choice-of-forum clause, while the guarantee provided by the Cerberus fund of the shell subsidiaries' obligations was governed by New York law and had a New York choice-of-forum clause.[112] The Cerberus fund leveraged

104. *See id.*

105. *See* Sorkin, *supra* note 88; Donovan, *supra* note 101.

106. *See* Verified Complaint at 1, United Rentals, Inc. v. RAM Holdings, Inc., 937 A.2d 810 (Del. Ch. 2007) (No. 3360-CC); Matthew Karnitschnig & Lingling Wei, *Economy Conspires to Dog Cerberus: United Rentals Sues over Collapsed Deal; Chrysler Loans Stall*, WALL ST. J., Nov. 20, 2007, at C1.

107. *See United Rentals*, 937 A.2d at 830–31.

108. *Id.*

109. *See id.* at 819, 831–32.

110. *Id.* at 832–33.

111. *See* The Dog Bites: A True Story, M&A Law Prof Blog, http://lawprofessors.typepad.com/mergers/2007/11/united-rentals-.html (Nov. 15, 2007).

112. *See* Cerberus Sues in New York, M&A Law Prof Blog, http://lawprofessors.typepad.com/mergers/2007/11/cerberus-sues-i.html (Nov. 23, 2007). 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. For a discussion of why lawyers could agree to such a disjunction, see *infra* notes 262–66 and accompanying text.

this disjunction to bring a separate suit in New York for declaratory relief that the separate terms of its guarantee limited its liability to $100 million.[113] The New York lawsuit, though, was never substantively litigated because Chancellor Chandler, the judge in the Delaware Chancery Court, found in favor of Cerberus.[114] This case was ultimately a contract dispute and Chancellor Chandler applied standard contract interpretation principles to find the contract language ambiguous and to uphold Cerberus's reading of the agreement.[115] When URI announced that it would not appeal this decision, Cerberus promptly terminated the acquisition agreement and paid URI $100 million.[116]

The URI-Cerberus dispute and Cerberus's subsequent termination of their agreement resulted in a further deterioration of the reputational force preventing the exercise of a reverse termination fee provision. In the period from December 2007 through February 2008, three additional private equity transactions would be effectively terminated: the pending acquisitions of PHH Corp., Reddy Ice Holding, Inc., and Myers Industries, Inc.[117] In each case, no MAC claim was publicly asserted; instead, the acquirers merely exercised the reverse termination fee provision in their agreements to exit the transaction.[118] In each instance, the agreement clearly permitted this action.[119] Thus, by early 2008, the fundamental

113. *See* Complaint at 1–2, Cerberus Partners, L.P. v. United Rentals, Inc., No. 07-603876 (N.Y. Sup. Ct. Nov. 21, 2007).

114. *United Rentals*, 937 A.2d at 845.

115. Chancellor Chandler found the language of the contract to be ambiguous and therefore looked to extrinsic evidence to find an objective, reasonable meaning of the contract language. He then applied the forthright negotiator rule to find that URI knew or should have known Cerberus's understanding of the contract, but did not seek to correct it. *Id.* at 834–43.

116. *See* United Rentals, Inc., Current Report (Form 8-K), § 2.01 (Dec. 26, 2007).

117. *See* Reddy Ice Holdings, Inc., Current Report (Form 8-K), § 1.02 (Feb. 1, 2008) [hereinafter Reddy Current Report]; PHH Corp., Current Report (Form 8-K), § 1.01 (Jan. 7, 2008) [hereinafter PHH Current Report]. Myers Industries and its private equity acquirer, GS Capital Partners, agreed on December 10, 2007, to postpone the completion of their transaction to April 30, 2008. In connection with this postponement, GS Capital Partners paid Myers a $35 million reverse termination fee and confirmed to Myers that no MAC existed. Press Release, Myers Indus., Inc., Myers Industries and GS Capital Partners Agree to Extend Closing Date of Proposed Acquisition (Dec.10, 2007), *available at* http://www.myersindustries.com/pdf/2007_GSCP_Purchase/12_10_07_MyersInd_GS_Extension.pdf [hereinafter Myers Press Release I]. The actual agreement was subsequently terminated on April 4, 2008. Press Release, Myers Indus., Inc., GS Capital Partners & Myers Industries Terminate Merger Agreement (Apr. 4, 2008), *available at* http://www.myersindustries.com/pdf/2007_GSCP_Purchase/04_04_08_Myers_GSCP_Terminate.pdf.

118. *See* Reddy Current Report, *supra* note 117, § 1.02; PHH Current Report, *supra* note 117, § 1.01; Myers Press Release I, *supra* note 117.

119. *See* Reddy Ice Holdings, Inc., Agreement and Plan of Merger (Form 8-K, Exhibit 2.1), § 9.7(b) (July 2, 2007); Myers Indus., Inc., Agreement and Plan of Merger (Form 8-K, Exhibit 10.1), § 8.6(f) (Apr. 24, 2007); PHH Corp., Agreement and Plan of Merger (Form 8-K, Exhibit 2.1), § 9.10

understanding 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 was realized. Reverse termination fee provisions appeared to become exercisable without significant reputational impact or other external normative constraints.

C. The Failure of Specific Performance

The economics and parameters of the pure reverse termination fee structure were largely redefined by the fall 2007 wave of collapsed private equity acquisitions. By 2008, most of these deals had either been terminated or consummated in accordance with their terms. Into the new year, however, a number of significantly larger multi-billion dollar private equity transactions remained pending. The majority of these were structured utilizing a specific performance reverse termination fee structure rather than a pure reverse termination fee.[120] The closing of these transactions was delayed into the winter of 2008 due to regulatory or financing issues.[121] 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.[122] Given that the acquirers could not simply terminate their obligations, they instead waited, delaying the deal and hoping that the credit and stock markets improved sufficiently to enable completion of their transactions.[123]

But as the credit crisis continued into 2008 and the economic cycle trended further downward, these transactions continued to be stressed by extrinsic shocks.[124] The result was another wave of litigation, this time implicating the viability of the specific performance form of private equity structure. The first of these disputes occurred at the end of January 2008

(Mar. 15, 2007).

120. The five biggest pending private equity acquisitions were the buyouts of Alliance Data Systems, Inc., BCE, Inc., Clear Channel Communications, Inc., Huntsman Corp., and Penn National Gaming, Inc. Only BCE and Clear Channel contained a pure form of the reverse termination fee structure. DAVIDOFF, *supra* note 81 (manuscript at 75–76).

121. *See generally* Bill Barnhart, *Acquisitions, Mergers Follow Natural Course*, CHI. TRIB., Jan. 30, 2008, at C7 (describing the state of the mergers and acquisitions market in early 2008).

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

123. *See* DAVIDOFF, *supra* note 81 (manuscript at 75–76).

124. *See* Heidi N. Moore, *The Buyout Financing Backlog: Are We There Yet?*, DEAL JOURNAL, WALL ST. J., Jan. 30, 2008, 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 around $250 billion as of January 2008).

and arose out of the pending sale of Alliance Data Systems, Inc. ("ADS") to funds affiliated with The Blackstone Group. At that time, it was disclosed that the Office of the Comptroller of the Currency ("OCC") was refusing to grant a required regulatory approval for ADS to be acquired by Blackstone.[125] The OCC justified its refusal on the grounds that the postacquisition leverage of ADS would leave ADS insufficiently capitalized to support its bank subsidiary.[126] The OCC did, however, express a willingness to reverse its position if the acquiring Blackstone fund itself provided a backstop: a $400 million guarantee of ADS's bank liabilities effective upon completion of the sale.[127]

On January 29, 2008, ADS sued in Delaware Chancery Court to compel the Blackstone fund to provide this guarantee.[128] ADS had negotiated an acquisition contract that provided that ADS could sue to force performance of the Blackstone shell subsidiaries' obligations under the agreement.[129] This arguably included the subsidiaries' contractual obligation to use reasonable best efforts to obtain any necessary regulatory approvals, including OCC clearance, for the transaction.[130]

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.[131] Blackstone countered that the language of the contract was different than what ADS claimed; specific performance was only available in the case of a financing failure.[132] Yet again, the lawyers had left a key provision ambiguous and the outcome uncertain.[133] Blackstone also argued that ADS

125. *See* Michael J. de la Merced, *Deal to Buy Credit Card Processor Is in Peril*, N.Y. TIMES, Jan. 29, 2008, at C4.

126. *See* Verified Complaint ¶¶ 6–9, Alliance Data Sys. Corp. v. Aladdin Solutions, Inc., No. 3507-VCS (Del. Ch. Jan. 29, 2008), *available at* http://www.sec.gov/Archives/edgar/data/1101215/000129993308000505/exhibit2.htm [hereinafter ADS Verified Complaint].

127. *Id.* ¶ 12.

128. *Id.* ¶¶ 1, 14; Michael J. de la Merced, *Credit Card Processor Sues Blackstone to Finish Buyout*, N.Y. TIMES, Jan. 31, 2008, at C6.

129. *See* Alliance Data Sys. Corp., Agreement and Plan of Merger (Form 8-K, Exhibit 2.1), § 9.8.2 (May 17, 2007).

130. *See* ADS Verified Complaint, *supra* note 126, ¶¶ 11–13.

131. *See* Transcript of Scheduling Conference at 13–16, *Alliance Data Sys.*, No. 3507-VCS (Del. Ch. Feb. 4, 2008), *available at* http://graphics8.nytimes.com/images/blogs/dealbook/ADSxscript.pdf [hereinafter ADS Scheduling Conference].

132. Defendants' Opening Brief in Support of Their Motion to Dismiss at 15–16, *Alliance Data Sys.*, No. 3507-VCS (Del. Ch. Feb. 4, 2008), *available at* http://lawprofessors.typepad.com/mergers/files/ads_aladdin_brief_in_support_of_motion_to_dismiss_2.pdf.

133. *See Alliance Data's Complaint*, DEALBOOK, N.Y. TIMES, Jan. 31, 2008, http://dealbook.blogs.nytimes.com/2008/01/31/alliance-datas-complaint.

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.[134] The Blackstone fund's only obligation was under its equity commitment letter issued to its subsidiaries and its own guarantee of the reverse termination fee.[135] 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.[136]

Blackstone's response highlighted a fundamental limitation on 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 unless the private equity fund voluntarily agreed to support any additional 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.[137] The shell subsidiaries could be required under this clause to sue their parent, a Blackstone fund, for any additional sums or contractual obligations required to satisfy regulatory demands. The meaning of reasonable best efforts under Delaware law, however, had yet to be addressed substantively in any court and was therefore uncertain.[138] Vice Chancellor Strine, the judge assigned to adjudicate ADS's complaint, also openly questioned ADS's argument in a hearing; he correctly noted that the Blackstone fund was not contractually bound to provide the OCC-demanded guarantee in this structure, so the grounds for any lawsuit by the Blackstone subsidiaries against their parent would likely be slim.[139] 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

134. ADS Scheduling Conference, *supra* note 131, at 31–35.

135. *Id.*

136. *Id.*

137. *Id.* at 21–24.

138. A Westlaw search conducted on March 20, 2009, for the phrase "reasonable best efforts" in the Delaware Cases database revealed only seventeen cases even mentioning the term. None of them offered an interpretation of the meaning of the term.

139. *See* ADS Scheduling Conference, *supra* note 131, at 39–42.

completing the transaction as the reason for this withdrawal.[140]

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 toward private settlement due to the prohibitive costs of lawsuits.[141] But in the private equity context, the relative costs of litigation are low compared to the billions in value at stake.[142] Litigation thus served three purposes in the post-August 2007 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.[143] For example, even though Blackstone had reverted to a formalistic view of the contract, ADS was still attempting to invoke extracontractual norms to complete the transaction. Despite ADS's apparently weak legal case, the company asserted in court that this litigation was about enforcing "a commitment from [Blackstone] in writing to close this [transaction] as expeditiously as possible."[144]

Third, litigation provided a forum for the parties to obtain a quick assessment of the risks of an adverse judgment and pushed them toward resolution of their disputes. This was unique to private equity disputes and

140. *See* Press Release, Alliance Data Sys. Corp., Alliance Data Files Notice of Voluntary Dismissal of Lawsuit (Feb. 8, 2008), *available at* http://www.alliancedata.com/news/newsreleases.html?viewrelease=1106159. Blackstone did not follow through on its public commitment. The agreement was subsequently terminated, and the parties proceeded to litigate the issue of whether Blackstone was required to pay the $170 million reverse termination fee. *See* Phil Milford, *Alliance Sues Blackstone for $170 Million Fee in Dropped Buyout*, BLOOMBERG, May 31, 2008, http://www.bloomberg.com/apps/news?pid=20601127&refer=law&sid=a54ZIHZ3jl2U. On January 15, 2009, Vice Chancellor Strine dismissed all of ADS's claims. He based his decision primarily on the failure of ADS to secure the Blackstone fund as a party to the Agreement. *See* Alliance Data Sys. Corp. v. Blackstone Capital Partners V L.P., 963 A.2d 746, 750 (Del. Ch. 2009).

141. *See* Hill, *supra* note 26 (manuscript at 3).

142. *Cf.* Claire A. Hill, *A Comment on Language and Norms in Complex Business Contracting*, 77 CHI.-KENT L. REV. 29, 54 (2001) (arguing that making contracts easier for courts to interpret may have "very low, or even negative, expected value").

143. This is similar to the channeling theory of contracts, which states that parties use contracts to speak publicly about their relationship. *See* Lon L. Fuller, *Consideration and Form*, 41 COLUM. L. REV. 799, 801–03 (1941).

144. *See* ADS Scheduling Conference, *supra* note 131, at 66. This attempt to enforce reputational norms is also illustrated by a quote from the statement released by Huntsman Corp. upon being sued by Hexion Specialty Chemicals, 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." Peter Lattman, *Merger Arbs: The Hexion-Huntsman Horror Show*, DEAL JOURNAL, WALL ST. J., June 19, 2008, http://blogs.wsj.com/deals/2008/06/19/merger-arbs-the-hexion-huntsman-horror-show.

due to the overwhelming selection of Delaware in acquisition agreements as the forum for these disputes.[145] The Delaware courts have a reputation for quick and efficient adjudication and they obliged in these disputes, acting quickly to adjudicate them. The Delaware judges also pushed the parties toward resolution of their disputes through their pretrial opinions and public statements.[146] Illustratively, ADS's withdrawal of its suit was likely influenced by Vice Chancellor Strine's negative comments on its case.[147]

The ADS litigation ultimately exposed the limits of the private equity structure with respect to its contractual terms. A second dispute involving the sale of Clear Channel Communication, Inc.'s television station business to Providence Equity Partners would highlight the more direct difficulty of forcing shell subsidiaries to enforce and draw on their own financing commitments. The Clear Channel television station dispute unfolded during February 2008 with litigation in two jurisdictions. Wachovia Corp. sued the Providence Equity shell subsidiaries in a North Carolina court to terminate Wachovia's obligations under its debt commitment letter to finance the subsidiaries' acquisition of Clear Channel's television station business.[148] 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.[149] Both litigations were resolved in March 2008 with the filing of a settlement which included a reduction of the purchase price.[150] But a notable hearing before Vice Chancellor Strine highlighted the difficulty of forcing these shell subsidiaries to act when their private equity 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.[151] The shell subsidiaries' obligation to use reasonable best

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145. *See infra* note 264.

146. *See* Steven M. Davidoff, *Battle-Tested Delaware*, DEALBOOK, N.Y. TIMES, Nov. 4, 2008, http://dealbook.blogs.nytimes.com/2008/11/04/battle-tested-delaware.

147. *See supra* notes 139–40 and accompanying text.

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

149. *Another Broken Deal Ends Up in Court*, DEALBOOK, N.Y. TIMES, Feb. 17, 2008, http://dealbook.blogs.nytimes.com/2008/02/17/another-broken-deal-ends-up-in-court.

150. *See* Andrew Ross Sorkin & Michael J. de la Merced, *Lawsuit Is Settled over Sale of Clear Channel's TV Unit*, N.Y. TIMES, Mar. 15, 2008, at C3.

151. Transcript of Oral Argument and Ruling on Motion to Expedite at 80–81, Clear Channel Broad., Inc. v. Newport Television LLC, No. 3550-VCS (Del. Ch. Feb. 26, 2008), *available at* http://lawprofessors.typepad.com/mergers/files/bd022682.ecl.pdf.

efforts to obtain financing would thus be interpreted to include a search for financing and funds from parties other than the recalcitrant private equity firm.[152]

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.[153] The dual litigation in the Clear Channel TV Station dispute that resulted from differing forum-selection clauses in the financing documents and acquisition agreement also raised the real possibility that the structure could completely collapse.[154] In other words, not only could the private equity firm breach its equity commitment letters, but the financing banks could breach their debt commitment letters as well. This would create a situation where an 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. The suits would have to be in different 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.

D. The Failure of Financing

In the wake of the market disruption, the parties with the most to lose from the completion of any pending private equity acquisitions were the financing banks. So, it was not surprising that, in light of the financial crisis, evidence began to emerge that these banks were actively attempting to terminate these transactions. In the fall of 2007, lenders in the private equity acquisitions of HD Supply, Inc. and Reddy Ice Holdings, Inc.

152. *See id.*

153. The legal availability of specific performance in a cash transaction was, in any event, still an uncertainty in many states, including Delaware. Specific performance is a remedy granted only when monetary damages are inadequate. *E.g.*, *In re* IBP, Inc. S'holders Litig., 789 A.2d 14, 52 (Del. Ch. 2001). Vice Chancellor Strine had granted specific performance of an acquisition in the seminal case of *IBP, Inc. v. Tyson Foods, Inc. Id.* at 83. Practitioners, however, still speculated that that 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*, DEALLAWYERS.COM BLOG, Dec. 4, 2007, http://www.deallawyers.com/ blog/archives/000838.html.

154. The reason for this dichotomy is that bank financing arrangements historically have been governed by New York law while, since 2005, private equity agreements have been governed largely by Delaware law. For a discussion of the failure to harmonize these clauses, see *infra* notes 262–66 and accompanying text.

interpreted their debt commitment letters to allow them to attempt to escape financing the renegotiated transactions.[155] In each of these deals, the private equity firms had renegotiated a lower purchase price with the acquirees. However, the financing banks had asserted that the renegotiation of the terms of the transaction constituted an adverse change under the banks' debt financing letters, which entitled the banks to terminate their obligations to finance the transactions.[156] The Reddy Ice transaction ultimately was terminated through payment of a reverse termination fee by the private equity firm, while the banks' position forced a renegotiation of the HD Supply transaction.[157] 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.[158] Presumably, they did this so as to incentivize the private equity firms to terminate the transaction.

In all three of these renegotiated transactions, the disputes and arrangements remained private and did not result in any litigation or public dispute.[159] The stresses in the relationship between banking and private equity, however, broke to the surface in the litigation surrounding the Clear Channel television 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.[160] Although the litigation was settled by Wachovia before any decision could be rendered, Wachovia achieved a reduction of its financing commitment in the settlement.[161]

The most significant failure in the private equity and lender relationship occurred in the litigation over the $26 billion purchase of Clear Channel by Bain Capital, LLC and Thomas H. Lee Partners. On March 26, 2008, Bain Capital and Thomas H. Lee sued their financing banks in New York Supreme Court.[162] In their complaint, the private equity firms alleged

155. *See* Henny Sender, Dennis K. Berman & Robin Sidel, *Home Depot Hit as Credit Crunch Squeezes Deals*, WALL ST. J., Aug. 27, 2007, at A1; David Carey & Vipal Monga, *Morgan Stanley Hints at Pull from Reddy*, THEDEAL.COM, Sept. 13, 2007, http://www.thedeal.com/servlet/Satellite?pagename=NYT&c=TDDArticle&cid=1188299438171.

156. *See* Sender et al., *supra* note 155.

157. *See* Reddy Ice Holdings, Inc., Current Report (Form 8-K), at 2 (Jan. 31, 2007); Sender et al., *supra* note 155.

158. *See* Andrew Ross Sorkin, *Acxiom Shows Breaking Up Is Costly*, N.Y. TIMES, Oct. 10, 2007, at C11.

159. *See* Vipal Monga, *When Friends Fall Out*, THEDEAL.COM, Sept. 21, 2007, http://www.thedeal.com/servlet/Satellite?pagename=hpa&p=M4YDAR1&c=TDDArticle&cid=1190001818655.

160. *See* Sorkin & de la Merced, *supra* note 148.

161. *See* Sorkin & de la Merced, *supra* note 150.

162. The banks were Citigroup, Deutsche Bank AG, Credit Suisse Group, Morgan Stanley, Royal Bank of Scotland plc, and Wachovia Corp. *See* Verified Complaint ¶ 2, BT Triple Crown Merger Co. v.

that the banks, in an attempt to terminate their obligations under their debt commitment letter, breached the letter by demanding unreasonable terms in the final negotiated credit documentation. The banks were incentivized to do this since they would incur an estimated $2.6 billion collective loss if they were forced to finance the transaction, as market conditions had changed that substantially from the time the banks had initially agreed to the financing terms in their debt commitment letter.[163]

The private equity firms asserted that these newly demanded terms violated the requirement in the debt commitment letter that the final negotiated credit agreements "shall contain the terms and conditions set forth in this Commitment Letter and shall be customary for affiliates of the Sponsors."[164] 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. This language thus ensured that the banks could not obtain a more onerous deal than previously agreed by the private equity firms in prior acquisitions.

The banks countered that the seventy-one page debt commitment letter was unenforceable because it contained too many open terms. The banks argued that only with final documentation would the contract be sufficiently complete to be enforceable.[165] In addition, the banks claimed that a specific performance remedy was unavailable to the private equity firms and that they could only collect money damages.[166] 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 and the liability waivers therein.[167]

This dispute settled with a renegotiated price, an increase in the interest rate on the bank debt, and a decrease in the amount of debt financing provided by the banks.[168] The litigation settled, but its impact

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Citigroup Global Mkts. Inc., No. 08-600899 (N.Y. Sup. Ct. Mar. 26, 2008), *available at* https://iapps.courts.state.ny.us/fbem/DocumentDisplayServlet?documentId=beRQdV7wtSzIc1dDaDChlA==&system=prod.

163. *Id.* ¶ 51.

164. *Id.* ¶ 40.

165. *See* Memorandum of Law in Support of Defendants' Motion for Summary Judgment at 21–25, *BT Triple Crown Merger Co.*, No. 08-600899 (N.Y. Sup. Ct. Apr. 10, 2008), *available at* http://graphics8.nytimes.com/images/blogs/dealbook/CCUdismissmotion.pdf.

166. *Id.* at 16–21.

167. *Id.* at 10–16.

168. *See* Clear Channel Commc'ns, Inc., Current Report (Form 8-K) (May 14, 2008). For a more detailed discussion of the settlement, see Heidi N. Moore, *Behind the Psychology of the Clear Channel Settlement*, DEAL JOURNAL, WALL ST. J., May 14, 2008, http://blogs.wsj.com/deals/2008/05/14/behind-

was clear. 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.

IV. NEGOTIATING THE STRUCTURE OF PRIVATE EQUITY

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

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.[169]

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.[170] 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.[171] The net effect was to deprive acquirees of the full reputational closing force they had likely counted on when negotiating their agreements.[172]

Failure of Specific Performance. The attorneys negotiating the specific performance mechanism of the reverse termination fee structure did so with the belief that it was an enhanced form of the reverse

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the-psychology-of-the-clear-channel-settlement.

169. *See, e.g.*, Nowicki, *supra* note 94, at 2–4.

170. *See supra* note 101 and accompanying text.

171. *See supra* Part III.B.

172. In at least one significant post-August transaction, the failed buyout of Acxiom, the private equity acquirer invoked a MAC provision, and the similar prospect of lenders doing the same forced a settlement at the lower reverse termination fee in a transaction with a two-tiered reverse termination fee (a higher fee was due if the acquirer simply breached its obligations, but a lower one was payable if financing was unavailable). *See* Interview with Jerry C. Jones, *supra* note 91.

termination fee structure.[173] 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, and the difficulty of forcing shell subsidiaries to enforce debt and equity commitment letters with differing choice-of-law and choice-of-forum clauses.[174]

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.[175] The meaning of reasonable best efforts, however, is still uncertain under Delaware law.[176] Moreover, the private equity parties subject to this clause were shell subsidiaries with little or no assets.[177] 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 complete the acquisition. This is exactly what happened in the ADS litigation.[178]

Failure of Drafting. Finally, there were the first-order mistakes. The private equity agreements themselves contained ambiguities and conflicting provisions. The URI-Cerberus litigation was the most prominent example, but it was not the only one. In *Hexion Specialty Chemicals, Inc. v. Huntsman Corp.*, another dispute involving a private equity acquisition, the court also found that the contract was ambiguous on the availability of specific performance;[179] and in a number of other circumstances, such as in the ADS-Blackstone litigation and the SLM-Flowers consortium dispute, drafting errors and ambiguity also surfaced.[180]

173. *See supra* notes 77–78 and accompanying text. *See also* David Leinwand & Victor Goldfeld, *Stresses on the New LBO Deal Architecture: United Rentals Goes to Court*, MERGERS & ACQUISITIONS & CORP. GOVERNANCE (Cleary Gottlieb Steen & Hamilton LLP, New York, N.Y.), Jan. 2008, at 4, 7.

174. There was also uncertainty as to whether specific performance could even be awarded under Delaware law. *See* Kevin Miller, *The ConEd Decision—One Year Later: Significant Implications for Public Company Mergers Appear Largely Ignored*, M&A LAW. (West Legalworks, New York, N.Y.), Oct. 2006, at 1, 4.

175. *See, e.g.*, *supra* notes 129–30 and accompanying text.

176. *See supra* notes 138–40 and accompanying text.

177. *See, e.g.*, *supra* notes 134–36 and accompanying text.

178. *See supra* Part III.C.

179. Hexion Specialty Chems., Inc. v. Huntsman Corp., No. 3841-VCL, 2008 Del. Ch. LEXIS 143, at *82–87 (Del. Ch. Sept. 29, 2008).

180. *See supra* notes 97–98, 131–33 and accompanying text.

Shareholders and commentators attributed these lapses to a number of factors including lax oversight, failure to recognize and appreciate the risks of the private equity structure, and management's oft-conflicted role in these buyouts that led it to overlook the problems with this structure.[181] The lawyers for these acquirees were also criticized for negotiating these optional structures and were accused of failing to properly advise acquirees of the structures' inherent risk.[182] But this criticism belies a much more nuanced picture in the negotiation of these structures. On examination, acquirees and their lawyers did appear to make a number of miscalculations, but their failures were premised on other fault lines.

A. OPTIONALITY AND THE PRIVATE EQUITY STRUCTURE

1. 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.[183] 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 thus could 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 an acquiree in the event that it was exercised by the private equity firm. The amount ultimately paid also did not deter acquirers from exercising the option in many instances. Rather, the amount of the reverse termination fee was normatively set by reference to the termination fee typically paid by acquirees, approximately 3 percent of the transaction value.[184] The fee was set at 3 percent for acquirer and acquiree, making for

181. *See* Davidoff, *Breakup Fees*, *supra* note 9.

182. *See, e.g.*, Nowicki, *supra* note 94, at 5.

183. *See* Option to Buy, *supra* note 79.

184. From 2005 to 2007, the average size of a reverse termination fee was 2.6 percent of the transaction value. Author calculations from MergerMetrics Database. *Cf.* 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 193 private equity transactions, I calculated that during the period from 2004 to 2007, the reverse termination fee ranged from 0.5 percent to 10.8 percent of the transaction value, with a mean percentage value of 3.49 percent and a median of

a symmetrical penalty.[185]

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.[186] This latter fee was capped by Delaware case law and was designed to deter competing bids and to compensate bidders for the costs associated with making a trumped offer.[187] But the same principles did not apply in the reverse termination fee context. In a number of prominent instances, the fee did not deter exercise of the option and, in hindsight, the amount appeared to undercompensate acquirees for the losses incurred by the acquiree company and its shareholders.[188] 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.[189]

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.[190] The testimony in the URI-Cerberus dispute supports these assertions. In that dispute, the parties disagreed whether the termination language 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 understand the choice:

3.25 percent. Author calculations from MergerMetrics Database.

185. When asked how the reverse termination was set, one attorney confirmed that setting the reverse termination fee at 3 percent was an adoption of the norm for acquiree termination fees. Interview with Anonymous Mergers & Acquisitions Attorney (Oct. 22, 2008) [hereinafter Interview A]. *See also* Christopher J. Bellini, *Private Equity Deal Terms: The Song (Largely) Remains the Same*, PRIVATE EQUITY FOCUS (Dorsey & Whitney LLP, Minneapolis, Minn.), June 2008, at 3, 4 (stating that "[t]he cap was typically a reverse termination fee that mirrored the break-up fee paid by the target to the buyer in the event that it terminated the merger agreement in favor of a superior competing offer").

186. *See* Brazen v. Bell Atlantic Corp., 695 A.2d 43, 48–50 (Del. 1997) (applying a liquidated damages analysis to a termination fee in a strategic merger to determine the validity of the provision).

187. For a discussion of the appropriate size of a termination fee in the context of a change of control transaction, see *In re* Toys "R" Us, Inc. S'holder Litig., 877 A.2d 975, 1017–21 (Del. Ch. 2005).

188. *See* Monga, *supra* note 14 ("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 the risk of deal failure.").

189. *See, e.g.*, Nowicki, *supra* note 94, at 5.

190. *See, e.g.*, Interview A, *supra* note 185; Interview with Anonymous Mergers & Acquisitions Attorney (Nov. 4, 2008) [hereinafter Interview B]; Interview with Anonymous Mergers & Acquisitions Attorney (Nov. 4, 2008) [hereinafter Interview C]. *See also* Harvard Talk, *supra* note 10.

> Throughout the course of negotiation of the Merger Agreement, URI contends that it communicated to [the Cerberus 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 Merger 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 "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 Merger Agreement.[191]

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.[192] If the subsidiaries refused to perform, or if financing otherwise failed, the acquiree was left with no compensation or recourse against the private equity firms except through a veil-piercing or other creative litigation argument.[193] The reverse termination fee structure reduced optionality in the structure by imposing a penalty on private equity firms for their refusal to complete transactions. In its specific performance form, the structure purported to ensure that the acquisition would occur if all of the conditions to completion were fulfilled and financing was available.

2. 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. The question remains, however, why did acquirees

191. United Rentals, Inc. v. RAM Holdings, Inc., 937 A.2d 810, 818–19 (Del. Ch. 2007) (footnote omitted).

192. *See* Sorkin & Swedenburg, *supra* note 44, at 103–04.

193. The arguments in the ADS litigation—that a parent had a responsibility to its subsidiary—represent this type of creative lawyering. Unfortunately for acquirees though, a veil-piercing argument is often unavailable since the private equity guarantees typically contain strong no-recourse language. *See, e.g.*, Steven M. Davidoff, *The Private Equity Lawsuit of the Year*, DEALBOOK, N.Y. TIMES, Feb. 27, 2008, http://dealbook.blogs.nytimes.com/2008/02/27/the-private-equity-lawsuit-of-the-year (noting the language of the no-recourse guarantee in the acquisition of fifty-six television stations by Providence Equity from Clear Channel).

advised by their lawyers assume this transaction risk? Furthermore, why did lawyers set the size of the reverse termination fee through an inapposite norm rather than varying it depending on the circumstances of the transaction? Did acquirees and their attorneys fully comprehend the risks inherent in these structures? If so, why did they still agree 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 informed their boards of this optionality.[194] They did not, however, view the reverse termination fee as an option but rather as a limitation on liability for the private equity firms. The private equity firms were willing to give up their financing condition and provide a guarantee, but they wanted some assurances of a cap on their aggregate liability. Hence, the reverse termination fee was negotiated as a liability cap and not as an option.[195]

Participants also 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 on the interaction of contractual terms and extracontractual 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 on reputational norms and conventions, as well as other external forces, to fill perceived gaps in the contract.[196] Again, the judicial description of the bargaining between URI and Cerberus provides 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.[197]

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.[198] In this multiplayer game,

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194. *See supra* note 190 and accompanying text.

195. *See also* Harvard Talk, *supra* note 10.

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

197. United Rentals, Inc. v. RAM Holdings, Inc., 937 A.2d 810, 825 (Del. Ch. 2007).

198. *Cf.* R.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.

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 subsequently being perceived as reneging on their deals.[199] 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 public censure. This penalty, together with the required reverse termination fee, was presumed to be adequate to prevent exercise of this option.

The acquisition contract and its negotiation also served as a bonding mechanism, enhancing these norms and constraints. The negotiation process not only established the legal parameters of the agreement but, in the discourse of the parties, also established a relationship to sustain the transaction. Conversations outside the four corners of the contract solidified the acquiree's willingness to rely on these extracontractual 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

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Williamson, *Transaction-Cost Economics: The Governance of Contractual Relations*, 22 J.L. & ECON. 233, 242 (1979) (arguing that buyers and sellers have an interest in appropriating as much profit-maximizing gain as they can and that "[g]overnance structures which attenuate opportunism and otherwise infuse confidence are evidently needed").

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

> 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."[200]

A third force, the economic incentives of private equity firms, was also cited by attorneys as completing the private equity structure and justifying its contractual optionality.[201] Private equity firms are 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 a company. The transaction costs incurred to first enter into this agreement, and the commitment it represents, also pressure private equity firms to complete their transactions.[202]

The particular reputational and economic forces that influence private equity provide a strong explanation for why a different, more certain structure has historically been utilized for strategic transactions—acquisitions made by an operating company, such as General Electric Co., rather than a private equity firm. Strategic transactions lack the optional nature of private equity acquisitions. In strategic transactions, the historic structural norm is to eschew financing conditions and reverse termination fee structures.[203] Instead, acquiree companies obligate the acquirer to specifically perform the acquisition in case of a breach of the acquisition agreement.[204] Moreover, unlike the private equity context, these

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200. *United Rentals*, 937 A.2d at 826–27. Another example is from a *Wall Street Journal* article reporting on the acquisition agreement negotiations between Huntsman and Hexion. According to the article, Jon Huntsman, the chairman of Huntsman's board of directors,

> says 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 . . . . 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 Pulliam & Peter Lattman, *As Buyout Bust Turns Bitter, a Major Deal Lands in Court*, WALL ST. J., Sept. 9, 2008, at A1.

201. *See, e.g.*, Interview A, *supra* note 185.

202. *Cf.* John C. Coates IV & Guhan Subramanian, *A Buy-Side Model of M&A Lockups: Theory and Evidence*, 53 STAN. L. REV. 307, 359 (2000) (positing that bidders may remain committed to preagreed 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").

203. *Cf.* Steven M. Davidoff, *Wrigley and the Future of M&A*, DEALBOOK, N.Y.TIMES, May 1, 2008, http://dealbook.blogs.nytimes.com/2008/05/01/wrigley-and-the-future-of-ma (noting the novel nature of the merger agreement between Mars, Inc. and Wm. Wrigley Jr. Co., a strategic transaction that incorporated the reverse termination fee structure).

204. *See, e.g.*, Yair Listokin, *The Empirical Case for Specific Performance: Evidence from the IBP-Tyson Litigation*, 2 J. EMPIRICAL LEGAL STUD. 469, 470–71 (2005) (discussing the specific

agreements are secured by the assets of the acquirer.[205]

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 on the vicissitudes of the financing market to complete its transaction. But, many strategic acquirers employ substantial leverage to effect acquisitions while private equity funds themselves have assets, namely, the contractual commitments of their investors to fund acquisitions. Accordingly, a stronger explanation is that a strategic acquirer is not in the business of acquiring companies, as private equity firms are. 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. Thus, stronger contractual protections are justified.[206]

Acquiree attorneys relied on these forces to negotiate the structure of private equity. There, attorneys for acquirees asserted that this structure was the best deal available and that private equity firms were unwilling to agree to more certain terms.[207] Boards advised by their attorneys made the conscious decision to accept transaction premiums in exchange for accepting deal uncertainty.[208] Moreover, these attorneys also highlighted competitive bidding situations wherein private equity firms did indeed agree to strategic-type completion structures.[209] They cited the existence of these provisions in this context in order to justify their agreement as being merely a reflection of the competitive environment, the bargaining strength of the parties, and the consequent agreement achieved.

performance clause used in the strategic acquisition of IBP by Tyson).

205. *See, e.g.*, Anheuser-Busch Cos., Inc., Agreement and Plan of Merger (Form 8-K, Exhibit 2.1), § 9.5(c) (July 16, 2008) (providing that if InBev breaches its obligations under the acquisition agreement to acquire Anheuser-Busch, specific performance is available against InBev itself).

206. In the wake of the credit crunch, reverse termination fee clauses have begun to be used in strategic deals in order to provide flexibility to acquirers to terminate their transactions if their financing falls through. It remains to be seen whether these features will persist when the markets eventually stabilize. DAVIDOFF, *supra* note 81 (manuscript at 186).

207. *See* Monga, *supra* note 14 ("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 buyers of the company would sign without the conditional put. In addition, the board felt the chances the transaction would fall apart were slim.").

208. *See supra* note 190 and accompanying text.

209. *See, e.g.*, Davidoff & Baiardi, *supra* note 82, at 7–10 (detailing the competitive bidding by Lone Star Funds for Accredited Home Lenders and the specific performance contract negotiated by the parties). Interestingly, at no point in my interviews did anyone state that this certainty or uncertainty affected deal premiums. There is evidence that post-August 2007, there have been some attempts to relate these two, at least in public descriptions of the transaction negotiation. *See, e.g.*, Golden Telecom, Inc., Solicitation/Recommendation Statement (Schedule 14D-9), at 21–23 (Jan. 18, 2008) (detailing that the special committee of the Golden Telecom board of directors agreed to a reverse termination fee "in order to secure the increase in the offer price from $103.00 to $105.00 per share").

The notion that parties sometimes leave contractual terms incomplete or vague in order to reach a contract and otherwise to avoid a dispute is well discussed in contracts literature.[210] In that scenario, parties prefer to leave any further disputes to the courts and ex post facto incentives to negotiate in order to avoid such litigation, rather than fail to reach an agreement altogether.[211] 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 that existed. 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 due to reliance on extralegal forces and the consequent perceived unavailability of a better bargain.

B. OTHER FACETS OF THE PRIVATE EQUITY STRUCTURE

In this light, acquirees and their attorneys likely justified the agreement to a reverse termination fee structure as the only available bargain agreeable to private equity firms and otherwise completed by external forces. Even so, attorneys for acquirees 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, reviewing the final deal as the best available bargain.

In the negotiation of the reverse termination fee, the contract served as a bonding mechanism between the parties, and its negotiation as a vehicle to create a relationship between them.[212] This practice carried through to

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210. *See, e.g.*, B. Douglas Bernheim & Michael D. Whinston, *Incomplete Contracts and Strategic Ambiguity*, 88 AM. ECON. REV. 902, 920–22 (1998). It is a phenomenon that was also noted in the context of the URI transaction. *See* Ben Hallman, *Left at the Altar*, AM. LAW., Apr. 2008, at 92, 94 ("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 gap or an indefinite term rather than fail to achieve a bargain. *See, e.g.*, Lisa Bernstein, *Social Norms and Default Rules Analysis*, 3 S. CAL. INTERDISC. L.J. 59, 66 n.34 (1993); George S. Geis, *An Embedded Options Theory of Indefinite Contracts*, 90 MINN. L. REV. 1664, 1680–82 (2006).

211. Additionally, parties may calculate that the likelihood of certain contingencies is sufficiently remote that it is not worth the added negotiating cost or the increased risk of failure to complete a deal.

212. *See* Mark C. Suchman, *The Contract as Social Artifact*, 37 LAW & SOC'Y REV. 91, 111 (2003) (noting that "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-

other parts of the private equity contract negotiation. For example, in selecting the efforts to be required of shell subsidiaries to obtain regulatory approvals or alternative financing, lawyers typically negotiated for either reasonable best efforts and best efforts, with the latter considered a stronger contractual obligation.[213] 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 how they differed.[214] This misunderstanding was often enhanced by the lack of case law on the meaning of reasonable best efforts.[215]

Despite the confusion about the meaning of best efforts and its variants, the parties could signal their commitment to the transaction by selecting either 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 which "efforts" standard to use would orally establish the level of conduct expected of the parties under the agreement prior to the contract's execution. I believe that 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 contract, 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 to be wrong.[216]

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length exchanges between equally endowed strangers").

213. *See* Kenneth A. Adams, *Understanding "Best Efforts" and Its Variants (Including Drafting Recommendations)*, PRAC. LAW., Aug. 2004, at 11, 12–13 (asserting that lawyers' conventional understanding of best efforts and its variants is at odds with the case law).

214. *Id.* at 13–14 (noting that some courts have equated the two standards).

215. *See supra* note 138 and accompanying text.

216. 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. Instead, as in ADS, only the shell subsidiaries created by the private equity fund were a party to the acquisition agreement. *See* Penn Nat'l Gaming, Inc., Agreement and Plan of Merger (Form 8-K, Exhibit 2.1), at 1 (June 15, 2007).

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 extralegal interpretation of the contract, which served to create an understanding of the intentions of the parties that was at times at odds with the contract itself. The negotiation in the URI-Cerberus acquisition amply illustrates this. Eric Swedenburg, attorney at Simpson Thacher & Bartlett LLP ("Simpson Thacher") for URI, started the negotiations by insisting that this would not be an optional deal; rather, it would be one modeled on the specific performance form.[217] The failure of URI to obtain this deal structure was likely a signal of URI's commitment, one that 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 extralegal discourse, the signals it sent, and the understandings it led to also explain the existence of drafting errors, contract gaps, and the agreement of acquirers and acquirees to flawed and ambiguous contract terms. Attorneys for acquirees relied on extralegal contractual understandings and forces to ensure that the contract was completed. In this circumstance, they did not push to correct all of the errors in the contract or otherwise to make a more complete contract. Instead, they relied on these forces to forgo fixing the contract.[218] In other words, the attorneys felt that they could safely ignore these failings since other extralegal factors provided them with confidence that they would not matter.[219] Moreover, as

217. *See* United Rentals, Inc. v. RAM Holdings, Inc., 937 A.2d 810, 818–19 (Del. Ch. 2007).

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

219. In this instance, the lawyer primarily translated this granular language into broader concepts for the client to approve and understand, as they were the primary negotiator for their principal. But, in certain circumstances, the lawyer also appeared to be acting autonomously—making granular choices with little oversight or approval by the client itself. This points to another area of study in contractual negotiations: the communications between attorneys and their clients during negotiations. *See, e.g.*, Coates, *supra* note 15, at 1303 (examining the adoption of structural defenses by companies at the IPO stage and finding that "[c]orporate 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)"); George M. Cohen, *When Law and Economics Met Professional Responsibility*, 67 FORDHAM L. REV. 273, 275–79 (1998) (arguing that while self-interested behavior of lawyers may be inevitable, it is not all consuming, and legal rules can cause lawyers to be more ethical); Donald C. Langevoort & Robert K. Rasmussen, *Skewing the Results: The Role of Lawyers in Transmitting Legal Rules*, 5 S. CAL. INTERDISC. L.J. 375, 376–80 (1997) (positing a theoretical construct that lawyers may

the URI-Cerberus dispute showed, the extracontractual 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.[220] In essence, 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.[221] Second, the contract negotiation itself created a mechanism through which the parties could bond and gain an understanding of each others' commitment and intentions.[222] Third, the contract created its own mechanics pushing toward a completed transaction by establishing a formal relationship.[223] But the contract terms were also negotiated to be enforced and altered depending on the relational bonding of the parties. Even in the end game, the parties attempted to enforce their private understandings as well as reputational norms.[224] The ADS litigation ably illustrated this.[225]

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 commenced. This would force them to work toward 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 toward

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tend to overstate legal risk).

220. As Claire Hill has observed, the institutional structure of law firms often produces lawyers who are incentivized to produce "good enough" drafting; the assumption is that the specter of litigation and other transaction costs will prevent any errors from discovery or exploitation. *See* Hill, *supra* note 15, at 71–72.

221. *See* Suchman, *supra* note 212, at 110.

222. *Cf.* Hill, *supra* note 26 (manuscript at 3) (arguing that "[t]he contracting process, and the contract that results, serves importantly to create the parties' relationship and to set the stage for dispute-resolution consistent with preserving the relationship").

223. *See* Hill, *supra* note 142, at 47–48 (noting that despite common "technical" failures to meet closing conditions in contracts, a party entitled to assert a termination right in such circumstance often will close after a renegotiation instead).

224. *See, e.g.*, Andrew Willis, *BCE Deal on Track for August Closing*, GLOBE & MAIL (Can.), June 23, 2008, at B1 (discussing negotiations over the BCE buyout 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").

225. The statements by Huntsman during its litigation with Hexion are another example. *See supra* note 144 and accompanying text.

resolution of disputes and to air the parties' private understanding of the private equity structure and contract.[226]

In sum, the reverse termination fee was not the only result of extralegal considerations. The entire private equity structure was negotiated based on extralegal understandings and norms to be partially documented in the acquisition agreement. An example again comes from the failed URI-Cerberus transaction. In that transaction, Simpson Thacher, the attorneys for the acquiree, likely negotiated an ambiguous agreement, engaged in relational bonding in negotiating the contract, and pushed for a higher reverse termination fee to offset its failure to negotiate a more certain closing structure within the four corners of the contract itself.[227] The contract was not just negotiated for its bonding, signaling, and terminology, but also as a backstop in litigation.[228] In such a circumstance, this relationship and these understandings could engender further bargaining before and during litigation and could create a platform to enforce reputational norms.

V. 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 problems with the pre-August 2007 structure—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 URI, Simpson Thacher, was to be paid $6 million if the transaction was completed.[229] If the transaction did not close, then Simpson Thacher would only be paid its billed time, a lesser amount.[230] So, the question remains

226. *See supra* notes 131–32 and accompanying text.

227. *See supra* Part IV.A.2.

228. These forces likely pushed the parties to engage in settlement negotiations up to the eve of trial. *See* Zachery Kouwe, *Down to the Wire—Deadline for Cerberus*, N.Y. POST, Dec. 18, 2007, at 47.

229. *See* Transcript of Eric Swedenburg Deposition at 280, United Rentals, Inc. v. RAM Holdings, Inc., 937 A.2d 810 (Del. Ch. 2007) (No. 3360-CC).

230. *Id.* at 280–81.

why attorneys were so reliant on these extralegal considerations and, to the extent that they were aware of them, why they did not fix contractual flaws and ambiguities? Instead, these attorneys continued to rely, or perhaps over-rely, on extralegal forces and constraints.

The answer comes from another force: path dependency. The private equity structure, the boilerplate of private equity, appears to be one largely set by path dependencies.[231] But, the structure's stickiness is not solely due to network effects and excess transactional switching costs—the most commonly cited reasons for path dependency in boilerplate.[232] Rather, it is also the result of an agency problem. Private equity lawyers are not incentivized to rethink and renegotiate the boilerplate of private equity. They instead rely on preexisting, good-enough structures. Dependencies in these complex contracts are therefore strong and the structure is particularly resistant to externalized shock.[233] Accordingly, when it does happen, change trends toward the incremental and is likely to be added piecemeal on the existing structure, creating further ambiguity and flaw.[234]

A. THE NATURE OF PATH DEPENDENCY IN THE PRIVATE EQUITY STRUCTURE

In the past twenty years, there have been only two significant shifts in

231. I use the term boilerplate here broadly to include structure as well as contractual terms. *Cf.* Todd D. Rakoff, *Social Structure, Legal Structure, and Default Rules: A Comment*, 3 S. CAL. INTERDISC. L.J. 19, 25 (1993) ("In 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.").

232. *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 bonds and the movement to adopt collective action clauses in the indentures for this debt. *See* Robert B. Ahdieh, *Between Mandate and Market: Contract Transition in the Shadow of International Order*, 53 EMORY L.J. 691, 693–95 (2004); Robert B. Ahdieh, *The Role of Groups in Norm Transformation: A Dramatic Sketch, in Three Parts*, 6 CHI. J. INT'L L. 231, 231–37 (2005); Stephen J. Choi & G. Mitu Gulati, *Innovation in Boilerplate Contracts: An Empirical Examination of Sovereign Bonds*, 53 EMORY L.J. 929, 930–38 (2004); Anna Gelpern & Mitu Gulati, *Public Symbol in Private Contract: A Case Study*, 84 WASH. U. L. REV. 1627, 1628–32 (2006). 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, 965–72 (2006); William W. Bratton, Jr., *The Economics and Jurisprudence of Convertible Bonds*, 1984 WIS. L. REV. 667, 686–88; Hill, *supra* note 15, at 73–74; Michael Klausner, *Corporations, Corporate Law, and Networks of Contracts*, 81 VA. L. REV. 757, 817–18 (1995).

233. The most prominent example of this in another context is the collective effort involved in shifting sovereign bond terms from unanimous to collective action clauses. *See, e.g.*, Choi & Gulati, *supra* note 232, at 930–38; Gelpern & Gulati, *supra* note 232, at 1639–42.

234. *Cf.* Choi & Gulati, *supra* note 232, at 993–94 (positing that in the context of sovereign bond indentures, change to boilerplate comes from interpretive shocks that result in "bunches" of change).

the structure of private equity. In the 1990s, equity commitment letters were added and the terms of debt commitment letters enhanced.[235] In 2005, the SunGard transaction heralded a more substantive change in the structure by spurring the adoption of reverse termination fee provisions and the elimination of financing conditions.[236] 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 creating a fundamentally new configuration, these revisions rested on the prior structure and still retained its core—externalized financing through limited liability shell vehicles.

At a basic level, classic 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; transaction 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 is explained by shifting equilibrium among the parties; a new, efficient bargain is achieved as a result of events forcing the parties to take different bargaining positions.[237] The private equity structure has changed little due to the lack of such events.[238]

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," become boilerplate, and may persist due to network effects, informational deficits, and signaling effects which can create excessive transactional switching costs.[239] 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

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235. *See supra* notes 61–63 and accompanying text.

236. *See supra* notes 64–73 and accompanying text.

237. This comports with Gilson's theory of the transactional attorney as a transaction-cost engineer structuring a more valuable deal. *See* Gilson, *supra* note 16, at 253–56; Ronald J. Gilson & Robert H. Mnookin, *Foreword: Business Lawyers and Value Creation for Clients*, 74 OR. L. REV. 1, 7–14 (1995).

238. Even 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, 91–93 (1989); David Charny, *Hypothetical Bargains: The Normative Structure of Contract Interpretation*, 89 MICH. L. REV. 1815, 1819–20 (1991).

239. *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 exactly what 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 15 (Pierre Garrouste & Stavros Ioannides eds., 2001). For a more skeptical view, see STAN J. LIEBOWITZ, RE-THINKING THE NETWORK ECONOMY 31–34 (2002).

the bargain parties would necessarily negotiate absent these additional costs; optimal terms thus become suboptimal or unintentionally suboptimal terms remain suboptimal.[240]

In the private equity market, participants describe the private equity structure and its evolution as simply the market norm.[241] This is common terminology that negotiators typically utilize in setting the terms of complex contracts. That is, in negotiations, attorneys reference the market—the predominant or preexisting structure or boilerplate utilized by other market participants—to establish and validate their own proposed terms for the transaction being negotiated.[242] From interviews, this also appears true of the private equity market.[243] The pre-August 2007 private equity structure was premised on and negotiated from the structure utilized by others at the time.[244] In these circumstances, innovation is heuristically anchored to the market.[245] Path dependency is created by market participants' paying heed to the market norm and their desire not to stray too far.[246] In this light, the static nature of the private equity structure thus appears to be explained more by path dependency than a transactional efficiency story.

This, however, does not explain the parties' resort to a market norm or whether the norm itself is 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

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240. In other words, due to path dependency, a superior product may not necessarily be the successful one in the market as a result of actions by others. This happens when people adopt a different, less utility maximizing good, thereby creating self-reinforcing feedback loops that engender further adoption of the less superior good. *See* W. Brian Arthur, *Competing Technologies, Increasing Returns, and Lock-In by Historical Events*, 99 ECON. J. 116, 116–17 (1989). *Cf.* Frederick W. Lambert, *Path Dependent Inefficiency in the Corporate Contract: The Uncertain Case with Less Certain Implications*, 23 DEL. J. CORP. L. 1077, 1078 (1998) (arguing that "the case has not been made for the general application of path dependence to the contracting process, but unique attributes of certain contracts, such as the corporate bond indenture, may exist in a unique environment conducive to path dependent suboptimality"). For a discussion and criticism of reliance on path dependence as an economic theory, see Stan Liebowitz & Stephen E. Margolis, *Policy and Path Dependence: From QWERTY to Windows 95*, REGULATION, Summer 1995, at 33.

241. The assumption is that terms as agreed are efficient on their face. *See, e.g.*, Smith & King, *supra* note 23 (manuscript at 4 n.13).

242. *See* Russell Korobkin, *Inertia and Preference in Contract Negotiation: The Psychological Power of Default Rules and Form Terms*, 51 VAND. L. REV. 1583, 1586 (1998).

243. *See, e.g.*, Interview A, *supra* note 185; Interview B, *supra* note 190.

244. *See supra* Part II.B.

245. *See infra* notes 257–59 and accompanying text.

246. *See* Omri Ben-Shahar & John A.E. Pottow, *On the Stickiness of Default Rules*, 33 FLA. ST. U. L. REV. 651, 652–53 (2006). Kahan and Klausner attribute this, in part, to herd behavior. *See* Kahan & Klausner, *supra* note 239, at 355–58.

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 participants relied on 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 firms terminated acquisition transactions they would be seen as unwilling to keep their bargains. In the multiplayer, repeat private equity market, after such an event, future acquirees would become less willing to transact with them.[247] 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 also functioned to assure acquirees that acquisitions would complete.

Where the contract is only part of the understood bargain, attorneys may be incentivized to choose good-enough options.[248] Attorneys may stick to the market norm rather than attempt to optimize the transaction structure through further transactional engineering. They do so for at least two reasons. 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 may be noticed in the market and commented on, perhaps negatively. 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 extralegal 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.[249]

247. The private equity community is a small one, but the community ties in the private equity industry appear to be less than in the type of close-knit community scholars typically cite as a predicate for establishing relational contracting or extralegal dispute-resolution mechanisms. *See, e.g.*, ROBERT C. ELLICKSON, ORDER WITHOUT LAW: HOW NEIGHBORS SETTLE DISPUTES (1991) (examining extralegal dispute-resolution mechanisms in the cattle-ranching community of Shasta County, California).

248. *See* Hill, *supra* note 15, at 70–76 (asserting that economic, psychological, and other dynamics collectively function to engender imperfect contracts).

249. *See* Korobkin, *supra* note 242, at 1586; Russell Korobkin, *The Status Quo Bias and Contract Default Rules*, 83 CORNELL L. REV. 608, 611–12 (1998).

Thus, innovation is typically based on the prior structure and is incremental at best. Attorneys look to add value to transactions—that is, value which can be shown to their clients. But in doing so, these lawyers rely on market norms for guidance and are hamstrung by prior precedent. They seek to add value, but not too much value, as incentives to truly innovate in relational contracts are reduced since extracontractual forces will serve to complete the contract. 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.[250]

Substantive change, when it comes, is likely to be a result of external forces arising outside the traditional legal community. This change is akin to the "interpretative shocks" which some have theorized cause boilerplate to move substantively.[251] Even then, the forces militating against change in complex contracts work to keep any shift toward the incremental and premised on the prior structure.[252] This is an agency problem—attorney incentives work to hamper change and confine it within the structure itself.

The evolution of the private equity structure, a short-term relational agreement, comports with this theory. The structure has seldom changed in over two decades. The largest shift, the implementation of a reverse termination fee, 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 than the private equity market.[253] Moreover, the liquidity wave within the markets prior to the financial crisis was unprecedented.[254] 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

250. *See* Hill, *supra* note 15, at 75–81.

251. *See* Choi & Gulati, *supra* note 232, at 993–94.

252. *See* W. Scott Frame & Lawrence J. White, *Empirical Studies of Financial Innovation: Lots of Talk, Little Action?*, 42 J. ECON. LITERATURE 116, 121–22 (2004).

253. For example, in 1989 the high-yield debt market collapsed and First Boston was left holding $457 million in debt related to the leveraged buyout of Ohio Mattress. In order to avoid bankruptcy, First Boston was forced to sell a substantial equity interest in itself to Credit Suisse, a sale which eventually resulted in the complete acquisition of First Boston by Credit Suisse. *See The Burning Bed*, BUS. WK., May 7, 1990, at 127.

254. *See* Kevin Warsh, Governor, Fed. Reserve Bd., Speech at the New York University School of Law Global Economic Policy Forum, Financial Market Turmoil and the Federal Reserve: The Plot Thickens (Apr. 14, 2008) (transcript available at http://www.federalreserve.gov/newsevents/speech/warsh20080414a.htm).

on the saleability of the debt. This shift created value for private equity firms, allowing them to negotiate firmer debt commitment letters.[255] Acquirees in private equity captured some of this value in negotiations to foster the 2005 shift in the private equity structure.[256]

The change in the private equity structure was thus a response to events in the related credit market. The additional value that accrued to private equity firms was in part seized by lawyers for acquirees.[257] The private equity lawyer, however, was incentivized to graft any changes onto the preexisting private equity structure. Thus, the reverse termination fee structure was placed onto the pre-2005 private equity structure. This older structure permitted an acquirer to terminate the acquisition agreement in the event of a MAC to the acquiree company.[258] These MAC clauses were initially inserted into the structure in the 1980s, borrowed at that time from agreements for strategic transactions.[259] In grafting these new terms onto the private equity structure, lawyers failed to fully account for the issues surrounding this structure and its adaptability. Instead, they relied on good enough solutions and extralegal 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 was demonstrated in the evolution of private equity by the variety of reverse termination fee structures.[260] This explains the bargaining and diffusion of deal structures between 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 private equity firms to signal their intentions within the bounds of the contract.[261]

Another example of negotiation within the bounds of the structure

255. *See* Leinwand & Goldfeld, *supra* note 173, at 4. *See also Breaking Up Is Costlier to Do*, MERGERS & ACQUISITIONS J., Apr. 1, 2007 ("The prevalence of these fees is connected to the availability of capital, deal attorneys say.").

256. *See* Sorkin & Swedenburg, *supra* note 44, at 104.

257. *See* Interview A, *supra* note 185; *supra* notes 64–73 and accompanying text.

258. *See supra* note 82 and accompanying text.

259. *See* Ronald J. Gilson & Alan Schwartz, *Understanding MACs: Moral Hazard in Acquisitions*, 21 J.L. ECON. & ORG. 330, 335–37 (2005).

260. *See supra* notes 64–73 and accompanying text.

261. This microvariation is exacerbated by the "battle of the forms," which occurs in each transaction. Each major private equity law firm has its own form for a transaction, and each form is structured similarly but written in a different style and with slightly different wording for each of the common clauses. In the digital age, there is a merging of the forms, rather than a dominant form based on who writes the first draft. The result is often pidgin.

occurred in negotiation of choice-of-law clauses. Private equity contracts began to more frequently use Delaware for their choice of law after an adverse decision in the Second Circuit Court of Appeals was rendered in 2005 in *Consolidated Edison v. Northeast Utilities*.[262] *Consolidated Edison* limited the ability of acquirees to sue under New York law for monetary damages for lost share premium when an acquirer breached an acquisition agreement.[263] In order to ensure certainty on this issue, Delaware subsequently became the preferred choice of law for private equity contracts.[264] 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.[265] 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, and the accompanying shift to Delaware choice-of-forum clauses, failed to account for the continuing use of New York choice-of-law clauses in debt commitment letters. This resulted in multiple causes of actions under different laws in a number of private equity litigations. Lawyers simply failed to account in the structure of private equity for the interaction of these differing law and forum clauses in the event of litigation.[266]

The need for attorneys to show value also explains how new terms in

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262. Consol. Edison, Inc. v. Ne. Utils., 426 F.3d 524 (2d Cir. 2005).

263. *Consolidated Edison* held that neither an acquiree nor its shareholder could sue an acquirer for the premium agreed to be paid for shares of the acquiree under an acquisition agreement. *Id.* at 531. *See also* Miller, *supra* note 174, at 1 (discussing the implications of *Consolidated Edison*).

264. I find that from 2004 to 2007, 72.6 percent of private equity contracts had a Delaware choice of law. Author calculations from MergerMetrics Database. My findings demonstrate a reversal of the trend found by Theodore Eisenberg and Geoffrey Miller against Delaware law in acquisition agreements. In a sample of 412 merger agreements over a seven month period in 2002, they found that Delaware law was chosen only 32 percent of the time. *See* Theodore Eisenberg & Geoffrey Miller, *Ex Ante Choices of Law and Forum: An Empirical Analysis of Corporate Merger Agreements*, 59 VAND. L. REV. 1975, 1987 (2006).

265. *See, e.g.*, $NuCO_2$ Inc., Agreement and Plan of Merger (Form 8-K, Exhibit 2.1), § 9.02 (Jan. 29, 2008) (illustrating an acquisition agreement, under New York law, including language that damages "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" in the case of a breach of the agreement).

266. It was likely that these complications led Penn National Gaming to agree to terminate its own acquisition transaction with Fortress Investment Group and Centerbridge Partners. Penn National Gaming had a specific performance form of acquisition agreement, but the prospect of multiple litigations in differing forums likely led it to agree to settle. *See* DAVIDOFF, *supra* note 81 (manuscript at 78–79).

the private equity structure diffuse. The SunGard transaction involved the law firm of Simpson Thacher.[267] The firm's involvement as the initiators of the reverse termination fee structure can be explained by their prominent role as counsel in many private equity transactions: the firm was counsel on approximately 22 percent of all public private equity deals with a value greater than $100 million from January 1, 2004 through August 1, 2007.[268] The structure's use in such a significant transaction validated it for use by other parties.[269] In fact, Simpson Thacher publicly promoted its work on this structure in order to highlight its innovative nature.[270] The quick adoption reflected the large 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 they developed.[271] Here, change in the private equity context appeared to diffuse similarly to other corporate changes with interlocking, tight networks, such as the poison pill.[272] This is likely due to the smaller private equity legal community and their ability, as sophisticated parties, to rapidly respond to change. Again, though, this change was one that ultimately was incremental and brought on by external forces. It was also a change that benefited both acquirees and private equity firms. Acquirees saw this change as providing more completion certainty over the prior structure. Private equity firms agreed to this change because of the inclusion of a nonrecourse guarantee that prevented the veil-piercing argument that previously could have been made.[273]

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.[274] In the private

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267. *See* SunGard Data Sys. Inc., Press Release (Form 8-K, Exhibit 99.1), at 2 (Mar. 28, 2005).

268. *See* Author calculations from MergerMetrics Database. *See also* Choi & Gulati, *supra* note 232, at 994 (citing the role of Cleary Gottlieb Steen & Hamilton LLP in effecting change to unanimous-consent clauses in sovereign wealth bond indentures).

269. Here, the fact that the structure was publicized by Simpson Thacher may have been a vehicle to promote their own private equity clients by providing a superior transaction structure in competitive bidding situations. *See* Harvard Talk, *supra* note 10.

270. *See* Sorkin & Swedenburg, *supra* note 44.

271. *Cf.* Michael J. Powell, *Professional Innovation: Corporate Lawyers and Private Lawmaking*, 18 LAW & SOC. INQUIRY 423, 433–41 (1993) (discussing Wachtell Lipton's marketing efforts for its poison-pill innovation).

272. *See* David Strang & Sarah A. Soule, *Diffusion in Organizations and Social Movements: From Hybrid Corn to Poison Pills*, 24 ANN. REV. SOC. 265, 278–79 (1998).

273. *See supra* notes 59–60 and accompanying text.

274. This comports with the view of those who have described innovation in a world of unpatentable ideas as being driven by those who dominate the market and can therefore profit

equity model, barriers to entry are high. The attorneys who regularly represent the private equity firms and their acquirees are members of sizable, prominent law firms that 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 signals of inexperience by the party hiring them. Thus, they are largely prevented from entry. Moreover, when they do enter into the game, these new firms typically represent acquirees on a one-off basis.[275] Any innovation by them is not protected intellectual property and is a public good. It can be quickly taken advantage of by other, more prominent firms who can capture more value from such innovation.[276] These outsiders are therefore not highly incentivized to innovate. They 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 risk deviating from the 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.[277]

C. LAW FIRM CENTRALITY AND THE PRIVATE EQUITY STRUCTURE

The private equity world is a discrete one where a few select law firms represent the majority of acquirees and private equity acquirers.[278] This circumstance can function to further hamper and forestall innovation and change in the private equity structure. The following table sets forth the legal representation of private equity firms and acquirees in all private equity buyouts greater than $100 million from January 1, 2004 through

maximally from such innovation. *See* Frame & White, *supra* note 252, at 118–19.

275. From January 1, 2004, to August 1, 2007, 17.1 percent of law firms involved in private equity transactions greater than $100 million in value represented an acquiree or acquirer more than five times, while 48.8 percent did so only once. Author calculations from MergerMetrics Database.

276. *See* Suchman, *supra* note 212, at 104–05.

277. The model put forth here may be at odds with events in other corporate arenas such as the change and innovation evident in the venture capital community. There, the innovational mindset of the industry participants and separation from East Coast law firms nurtured a unique model erected by external law firms. *See* Mark C. Suchman, The Contracting Universe: Law Firms and the Evolution of Venture Capital Financing in Silicon Valley 32–33 (Jan. 2006) (unpublished manuscript, on file with author). *See also* Powell, *supra* note 271, at 434–35 (noting the innovation of Wachtell Lipton in devising the poison pill).

278. *Cf.* Mark C. Suchman & Mia L. Cahill, *The Hired Gun as Facilitator: Lawyers and the Suppression of Business Disputes in Silicon Valley*, 21 LAW & SOC. INQUIRY 679, 683 (1996) (noting about Silicon Valley venture capital lawyers that "[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").

August 1, 2007.

TABLE 1. TOP LAW FIRM REPRESENTATION[279]

	Both Acquiree and Acquirer Represented by Top Private Equity Law Firm	Neither Acquiree nor Acquirer Represented by Top Private Equity Law Firm	Either Acquiree or Acquirer Represented by Top Private Equity Law Firm
Transaction Size >$500 Million	40%	4%	21%
Transaction Size <$500 Million	12%	5%	18%
Total of all Private Equity Transactions from 1/1/2004-8/1/2008	52%	9%	39%

Table 2 reveals that representation of private equity firms is highly concentrated. A core group of twenty-two law firms represented a private equity firm in approximately 82 percent of transactions and was involved in 91 percent of all transactions. Six firms were ubiquitous during this time period and involved in a majority of transactions:

TABLE 2. REPRESENTATION BY SELECT TOP LAW FIRMS[280]

Law Firm	Law Firm Represented Acquiree	Law Firm Represented Acquirer	Total Transactions	% of PE Transactions from Jan. 1, 2004-Aug. 1, 2007 >$100 MM
Simpson Thacher & Bartlett	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%

279. Author calculations from MergerMetrics Database. One hundred and twenty-nine law firms were involved in 179 public private equity transactions with a value greater than $100 million from January 1, 2004, to August 1, 2007. Top private equity firms are the 22 firms that had 6 or more representations on a private equity deal during the applicable time period.

280. Author calculations from MergerMetrics Database.

Together, the tables show that, 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 are 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 as well. During the time period January 1, 2004, through August 1, 2007, acquirees were represented by a top private equity law firm in 61 percent of transactions.[281] In comparison, private equity firms were represented by a top law firm in 82 percent of transactions.[282] This figure is likely higher for private equity firms due to acquiree preferences to be represented by their traditional counsel.[283] These non-top firms are not as experienced in and are likely not as familiar with the private equity structure. Of the 129 law firms I found that represented a party in a private equity transaction during the time period from January 1, 2004 to August 1, 2007, 63 provided legal advice in only one private equity transaction.[284] And outside the top 22 law firms, these other 107 law firms represented an acquiree 69 percent of the time and a private equity firm 31 percent of the time.[285]

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 above, their incentives to do so in these circumstances are low.[286] 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. It is likely because of the need for this experience that, in a majority of circumstances, acquirees still retained a top private equity firm, experienced in structuring private equity transactions.

The top law firms' economic incentives may be skewed, however, because 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

281. Author calculations from MergerMetrics Database.

282. *Id.*

283. This may be due to, among other things, relationship-specific investments that incentivize acquirees in these circumstances to use their traditional counsel.

284. Author calculations from MergerMetrics Database.

285. *Id.*

286. *See supra* notes 274–77 and accompanying text.

would harm their ability to further obtain private equity business are lowered.[287] 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.[288] Reliance by attorneys on extracontractual forces works to cover for this possible conflict by allowing acquiree attorneys to otherwise justify the structure of private equity.[289]

D. THE OPTIMALITY OF THE PRIVATE EQUITY STRUCTURE

The question remains whether the private equity contract was an optimal one. But the role of, and forces on, attorneys and the nature of change in private equity contracts belie a term like optimal.[290] 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 that does not produce excess, unanticipated transaction costs, or an uneconomical remedy for a foreseeable eventuality.[291] The structure of private equity does not meet this test. Due to attorney agency costs, private equity is a path-dependent structure, resistant to change and created piecemeal from the preexisting structure. The private equity structure is also one that inherently and necessarily relies on extralegal forces to complete it. If these external forces fail, they are likely to expose the flaws that permeate the structure. The post-August 2007 events affecting the private equity structure provided

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287. *See* Lisa Bernstein, *The Silicon Valley Lawyer as Transaction Cost Engineer?*, 74 OR. L. REV. 239, 248 n.43 (1995). *See also generally* MACKLIN FLEMING, LAWYERS, MONEY AND SUCCESS (1997) (discussing the evolution of the large law firm and their incentives to collect fees).

288. *See generally* Gillian K. Hadfield, *Legal Barriers to Innovation: The Growing Economic Cost of Professional Control over Corporate Legal Markets*, 60 STAN. L. REV. 1689 (2008) (analyzing the effect of legal self-regulation on business entities, including the effect on motivation).

289. 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 extracontractual forces permitted acquiree attorneys to forgo innovating and bargaining over more favorable unfamiliar terms. This additional potential agency conflict, thus, likely was not a determinant force in setting the structure of private equity but rather a reinforcing one. Evidence for this comes from the URI litigation. In that transaction, Simpson Thacher represented the acquiree. From the trial transcript, the firm appears to have bargained hard within the bounds of the current private equity structure. *See supra* Part IV.A.2.

290. *Cf.* Kahan & Klausner, *supra* note 232, at 750–51 (arguing that the "put at par" event risk covenant feature in bond indentures was suboptimal).

291. 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 232, at 940–43 (discussing the debate over whether unanimous-consent clauses in sovereign wealth bond indentures are suboptimal); Kahan & Klausner, *supra* note 232, at 751 ("[T]he remedy provided to bondholders in most covenants is a put at par. This, however, is a faulty remedy. . . . [I]f market interest rates rise . . . the put would overcompensate bondholders and possibly deter efficient transactions.").

very real proof of these flaws. The structure of private equity is thus a suboptimal bargain.

VI. 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 against other legal and nonlegal factors. The attorney then drafts the contract to reflect this weighing, confirming their impressions through the dialogue and bonding of the negotiation itself.[292] The private equity contract, though, is a complex contract and, like all such contracts, is dependent on 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 and its negotiation, 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 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, creating more completion certainty. Third, to the extent these flaws actually created uncertainty they allowed acquirees and their attorneys to achieve a desired result—a completed deal—while preserving an option for later negotiation and bonding. 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

292. *Cf.* Powell, *supra* note 271 (describing attorneys as "legal entrepreneurs").

innovate. Lawyers and other transaction participants failed to predict the effects of a mass market disruption.[293] In other words, acquiree lawyers as agents over relied on these external forces to forgo innovative approaches to bridge the preexisting closing gap and fix the flaws in the private equity contract. This overreliance may have been enforced by the 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 overreliance—the market disruption may not have been predictable or otherwise rationally contemplated at the time these pre-August 2007 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 likely what attorneys will cite as the reason for the failure of private equity, 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, then one would predict that lawyers would reassess these forces in light of post-2007 events. One would further predict that this calculus would militate against a shift toward 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 acquirees.[294]

So far, however, this is not what has happened. Instead, the private equity structure has shifted in the opposite direction—toward a more private-equity-favorable model. Every one of the private equity transactions announced in the first five months of 2008 utilized a pure reverse termination fee structure.[295] This is a telling response. The nature of this shift marks a recognition that the drivers to closing in a private equity

293. *See* Megan Davies & Jessica Hall, *Buyout Spats Bruise Many, Damage Trust*, REUTERS, July 7, 2008, http://www.reuters.com/article/reutersComService4/idUSN0635867820080709 (quoting Marilyn Sonnie, a partner at the law firm Jones Day, saying that "[b]oards never really thought they were signing up for a deal that could just evaporate . . . . But a lot of them did").

294. *See* Bird & Levitsky, *supra* note 87 (discussing seller expectations for deals with more closing certainty in the private equity market); Andrew Ross Sorkin & Michael J. de la Merced, *The Fine Art of Deal-Making Gathers Dust*, DEALBOOK, N.Y. TIMES, Apr. 2, 2008, http://dealbook.blogs.nytimes.com/2008/04/02/the-fine-art-of-deal-making-gathers-dust ("Sixty-two percent of the respondents to the Brunswick poll said that reverse termination fees, payments that buyers can use to walk away from deals, will be tightened or amended over the next year.").

295. As of June 1, 2008, nine such transactions valued greater than $100 million existed. MergerMetrics Database. *See also* Steven M. Davidoff, *The More Things Change . . .* , DEALBOOK, N.Y. TIMES, Jan. 25, 2008, http://dealbook.blogs.nytimes.com/2008/01/25/the-more-things-change.

transaction substantially exist outside the contract language. It also represents a collapse of the bargain between private equity firms and acquiree companies that permitted more rigorous forms of the reverse termination fee structures to exist.[296] Ultimately, this response shows a failure of innovation on the part of attorneys to bridge the gap and find a solution that provides both acquirees and private equity firms with greater completion certainty.

The response of acquirees 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. By negotiating only incremental changes on the prior structure and relying on externalized forces, lawyers allow the burden of failure to be assumed by the companies rather than lawyers themselves. Again, there exists an agency cost. Because of this, however, the role of relational bonding in the contract stage becomes even more important. Not only are companies self-selecting for acquisitions, but they also need to ensure that the external forces to close will hold.[297] It is no surprise that the 2008 private equity acquisitions were mostly in industries less affected by the market disruption. Here, acquirees justified using the reverse termination fee structure due to their stable, cash-generative business models that would make them less resistant to any adverse impact by the economic crisis. This ensured that their business remained stable and that 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 extralegal 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 mean that there is

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

297. This likely explains the first instance where the private equity structure was utilized in a significant strategic transaction: Mars, Inc.'s agreement to acquire Wm. Wrigley Jr. Co. There, the parties likely relied on their post-completion arrangements for Wrigley management's continued operation of the acquired company to provide an extralegal force to justify the fee—namely, Wrigley management did not want the transaction to go through if Mars was unwilling, due to their need to work together in the future. *See* Davidoff, *supra* note 203.

always some hook that an acquirer can find to terminate or renegotiate 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.[298] This type of behavior was clearly on display in the private equity failures of the past years. The consequence is that in the private equity context, and likely complex contracts generally, norms are an important and inescapable component of a contract.[299]

This, combined with the other limitations in the private equity structure, has worked to make the response to the failure of private equity a muted, incremental one. The pure reverse termination fee model so far appears to have remained and has become the private equity structure. In fact, it has even been enhanced in certain instances by additional conditionality, such as by EBITDA conditions.[300] The specific performance model has been completely abandoned. As with other change in the private equity structure, this will likely remain the case until some externalized shock produces a new incremental shift in the boilerplate of private equity.[301]

Lawyers still act within this confined structure in order to show value to their clients. This is likely to result in lawyers repairing some of the drafting ambiguities and other smaller defects in the private equity model. This appears to have happened—in post-2007 private equity transactions, the contract language appears to be clearer and more carefully drafted.[302] In addition, many of the other flaws in the private equity model appear to have been 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 an economic incentive to

298. *See* Hill, *supra* note 26 (manuscript at 1–4).

299. The issue with private equity, thus, is not reliance on extralegal norms but overreliance.

300. An EBITDA condition is a condition that the acquiree will meet a set amount of earnings before interest, taxes, depreciation, and amortization ("EBITDA") before the buyout must be consummated. *See, e.g.*, Greenfield Online, Inc., Agreement and Plan of Merger (Form 8-K, Exhibit 2.1), § 6.02(d) (June 15, 2008).

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

302. *See* David Marcus, *Desperately Seeking Certainty*, THEDEAL.COM, July 18, 2008, http://www.thedeal.com/newsweekly/features/desperately-seeking-certainty.php (noting that "PE buyers have become more vigilant in rooting out dangerous ambiguities in contracts"); E-mail from Anonymous Hedge Fund Managing Director to Steven Davidoff (June 8, 2008, 14:12 EST) (on file with author).

force the cooperation of private equity funds. The response is an expected one based on the forces driving private equity. Lawyers have acted to show value and fix the easy flaws in private equity agreements. Where these are the flaws, the transaction costs to doing so are low. The fundamental structure, though, remains.[303]

VII. 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 revealed 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 to, and evolve.

The private equity attorney as transaction-cost engineer relies on more than just the words of the contract and law, but also on norms, conventions, bonding, and other extralegal factors to complete the contract. The structure of private equity, however, is not an efficient transactional structure. Reliance, and perhaps overreliance, on these extralegal forces create a path-dependent structure that dampens innovation, covers up possible attorney inefficiencies and conflicts, and allows flaws to creep into the private equity contract. In the private equity context, we saw these failures emerge through outright drafting errors and the serial collapse of private equity deals in the period from August 2007 through 2008.

The failure of private equity shows the limitations of transactional lawyering. Preliminary responses of attorneys to the private equity implosion confirm this, and also inform 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 in this Article continue to drag on the structure of private equity.[304]

303. I believe the actions of attorneys, acquirees, and private equity firms detailed in this Article support the neoformalists' view of contract. The shift in structure in the post-August 2007 world shows that contract participants, at least in a sophisticated business environment, can be responsive to market events. Nonetheless, endogenous factors such as legal transaction costs may prevent a complete adjustment. *Cf.* William J. Woodward, Jr., *Neoformalism in a Real World of Forms*, 2001 WIS. L. REV. 971, 972–73 (arguing that neoformalism lacks persuasive empirical evidence that is will cause people to take more care in making or reading contracts).

304. The failure to innovate in response to this shock is not only affecting acquirees, but also

APPENDIX. SELECTED TERMINATED AND RENEGOTIATED PRIVATE EQUITY TRANSACTIONS (AUG. 2007–DEC. 2008)

Ann. Date	Acquiree	Acquirer	Outcome
Nov. 16, 2006	Clear Channel Communications, Inc.	Bain & Co./Thomas H. Lee Partners	Renegotiated
Mar. 15, 2007	PHH Corp.	GE Capital Solutions/ The Blackstone Group	Terminated
Mar. 20, 2007	Affiliated Computer Services (ACS)	CEO led MBO/Cerberus Capital Management, L.P.	Terminated
Apr. 16, 2007	Sallie Mae (SLM Corp.)	JC Flowers & Co., LLC consortium	Terminated
Apr. 20, 2007	Clear Channel Communications, Inc. (Television Business)	Providence Equity Partners	Renegotiated
Apr. 24, 2007	Myers Industries, Inc.	Goldman Sachs Capital Partners	Terminated
Apr. 26, 2007	Harman International Industries, Inc.	Kohlberg Kravis Roberts & Co./Goldman Sachs Capital Partners	Terminated
May 16, 2007	Acxiom Corp.	ValueAct Capital/Silver Lake	Terminated
May 17, 2007	Alliance Data Systems, Inc.	The Blackstone Group	Terminated
May 31, 2007	CKx, Inc.	19X, Inc., Robert F.X. Sillerman, and Simon Fuller	Terminated
June 4, 2007	Accredited Home Lenders Holding Co.	Lone Star Funds	Renegotiated
June 15, 2007	Penn National Gaming Inc.	Fortress Investment Group LLC and Centerbridge Partners LP	Terminated
June 30, 2007	BCE, Inc.	Teachers Private Capital, Providence Equity Partners LLC, and Madison Dearborn Partners, LLC	Terminated
July 2, 2007	Reddy Ice Holdings, Inc.	GSO Capital Partners LP	Terminated

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private equity firms who, due to their reliance on optional structures, may not be able to effectively compete for acquisitions. *See* Vipal Monga, *Blackballed*, THEDEAL.COM, June 12, 2008, http://www.thedeal.com/newsweekly/features/blackballed.php (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 (emphasis added)).

July 12, 2007	Hunstman Corp.	Hexion Specialty Chemicals, Inc. (Apollo Management LP)	Terminated
July 23, 2007	United Rentals, Inc.	Cerberus Capital Management, L.P.	Terminated
July 23, 2007	Cumulus Media Inc.	Merrill Lynch Global Private Equity (MLGPE)	Terminated
Aug. 7, 2007	NetSpend Corp.	Capital One Financial Corp.	Terminated
Sept. 28, 2007	3Com Corp.	Bain Partners LLC/ Huawei Technologies Co., Ltd.	Terminated