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A Trap For The Unwary In Terminating M&A Transactions

Law360, New York (December 12, 2012, 4:38 PM ET) -- Your company might undertake a merger or acquisition for any number of reasons. It might wish to expand into new markets; to acquire valuable technology or other assets; and/or, of course, simply to grow the bottom line. No company ever wants to find itself hip-deep in litigation after taking a seat at the negotiating table. But that can and does happen — often when a company tries to "hedge its bets" in its contract with its acquisition target.

Imagine: You have signed an agreement to purchase another company upon the completion of due diligence efforts. As is customary, you have negotiated a walk-away clause should you determine "in good faith that there is a reasonable basis in law and fact to conclude that" the target has material unreported liabilities. You engage qualified counsel who reports, after intensive study, that the target does indeed have material unreported liabilities, and so you kill the deal. Soon thereafter, the target sues you for breach of contract. The trial court rules that you acted in honest reliance upon the advice of your counsel. The catch: your counsel erred, and the target company had no significant unreported liabilities.

Many corporate drafters might think that, in this situation, no breach of contract has occurred. However, most courts, including the Delaware Supreme Court, disagree. Buyer beware: your counsel's considered opinion does not immunize your company from a lawsuit — not if that opinion ultimately proves to be objectively wrong. To understand why, and to appreciate the different situations in which a court of law will enforce objective as opposed to subjective review of a party's termination rights, the corporate drafter should acquaint herself with Section 228 of the Restatement (Second) of Contracts (1981). It provides that:

> When it is a condition of an obligor's duty that he be satisfied with respect to the obligee's performance or with respect to something else, and it is practicable to determine whether a reasonable person in the position of the obligor would be satisfied, an interpretation is preferred under which the condition occurs if such a reasonable person in the position of the obligor would be satisfied.

In other words, even when a party attempts to reserve for itself the right to terminate based only upon its own "satisfaction" or subjective good faith, the courts, where practical, will impose upon the terminating party a "reasonable person" standard.

The Law of Satisfaction Clauses

Section 228 codifies longstanding common law on so-called “satisfaction clauses.” “That which the law shall say a contracting party ought, in reason to be satisfied with, that the law will say he is satisfied with.”[1] As Judge Richard Posner has explained, this rule of construction embodies the “presumption that the performing party would not have wanted to put himself at the mercy of the paying party’s whim.”[2]

The rule is not universal. Rather, as Judge Posner has further explained, “the presumption that the performing party would not have wanted to put himself at the mercy of the paying party’s whim is overcome when the nature of the performance contracted for is such that there are no objective standards to guide the court.”[3]

Thus, the key question is whether a contractual determination is one of a nature that a court can review based on objective criteria. As articulated by the New York Court of Appeals, subjectivity prevails where the object of the contract is “to gratify taste, serve personal convenience, or satisfy individual preference”; objectivity where the suitability of the goods is a matter of “mechanical fitness, utility, or marketability.”[4]

Objective vs. Subjective Standards

A review of recent case law provides some guidance as to the places in which the courts have drawn out this objective vs. subjective split. Following the Seventh Circuit’s lead in Morin Bldg. Prods. Co., supra — which involved a contract to build an addition to a Chevrolet plant — the courts have been particularly keen to opt for objectivity in the construction and real estate sectors, which share a well-defined set of customs and expectations.[5]

Bucking this trend is the Court of Appeals of North Carolina, which has recently held that North Carolina law applies only a subjective good faith standard to a provision on the adequacy of title insurance under a home construction contract.[6] Similarly, the Supreme Court of Mississippi has recently applied a subjective standard to a financing condition in a transaction to quire a commercial transaction.[7]

More typically, however, courts have opted for subjectivity only in those cases in which discretion is paramount, such as criminal plea agreements.[8] Other kinds of contracts recently held to merit only subjective review include civil litigation settlement agreements,[9] and employee background checks.[10]

Drafting efforts to move the dial from objective to subjective by inserting into contracts words such as “belief” and “good faith” have proven largely unsuccessful. First, in the context of sale of goods contracts, Article 2 of the Uniform Commercial Code provides that: “‘Good faith’ in the case of a merchant means honesty in fact and the observance of reasonable commercial standards of fair dealing in the trade.”[11]

Even in other contexts, a contractual right geared toward a party's "good faith" may still be measured under an objective analysis. For example, in J.D. Cousins & Sons Inc. v. Hartford Steam Boiler Inspection & Ins. Co., the Second Circuit held that a contract to perform boiler inspection services which enabled the authorized inspector to "make such inspections as he may deem necessary to permit him to certify [Code compliance] to the best of his belief," should be "adjudicated under the standard of objective reasonableness."[12]

Merger and Acquisition Agreements

In the M&A context, the stakes in interpreting these provisions can be high. In Rohn Indus. Inc. v. Platinum Equity LLC[13] for example, a dispute as to how to construe such a termination clause led to a $20-plus million judgment. The facts in that case are instructive.

On Nov. 27, 2002, Rohn Industries Inc., a cell phone tower maker, and Platinum Equity LLC, a private investment firm, entered into an Asset Purchase Agreement by which Platinum agreed to acquire substantially all of Rohn's assets. Rohn had once been a division of UNR Industries, a successor to Unarco Industries Inc., which manufactured asbestos products
until the 1970s.[14]

In 1983, UNR had filed for bankruptcy, due to its overwhelming asbestos liabilities. UNR's confirmed bankruptcy plan channeled all asbestos related claims to a trust, and discharged UNR of all of its asbestos related liability. The Seventh Circuit affirmed the injunction and discharge in a ruling penned by Judge Frank Easterbrook.[15]

By 2002, Rohn had long since severed its ties to UNR. Nevertheless, Platinum — fearing potential future asbestos litigation — added a provision to the parties' agreement allowing it to terminate if: "[Platinum] determines in good faith that there is a reasonable basis in law and in fact to conclude that ... as a result of the consummation of the [transaction, Platinum] could reasonably be anticipated to have any ... material liability for any asbestos-related claim."[16]

Notwithstanding the Bankruptcy Court's injunction and discharge (confirmed by the Seventh Circuit), Platinum, on the advice of bankruptcy counsel at an esteemed, white shoe firm, concluded that a transaction with Rohn would expose Platinum to asbestos-related liability. By all accounts, Platinum's concern was genuine, even if it ultimately proved mistaken. Based solely upon this provision, Platinum terminated the agreement.[17]

The case was tried before the Delaware Superior Court in December 2004. At trial, Rohn maintained that Platinum's concerns regarding asbestos liability were unfounded; i.e., that no reasonable person could have concluded it to be a proper basis for terminating the agreement. Platinum countered that it had terminated the agreement under a good faith belief that asbestos liability would create considerable problems for the company. Platinum further argued that by this subjective good faith standard, it was entitled to terminate the Agreement, regardless of whether or not its concern was an objectively reasonable one.[18]

On Nov. 22, 2005, the Superior Court entered judgment in favor of Platinum, holding that the Agreement conferred "discretion on Platinum to terminate the agreement so long as it behaved in good faith." The Superior Court explained that: "the legal advice that was provided to Platinum, though objectively unreasonable, … gave Platinum a basis in law to terminate the agreement." Rohn appealed.[19]

On appeal, the Delaware Supreme Court noted the trial court's application of a strictly subjective good faith analysis to Platinum's termination of the agreement:

The trial judge found no legal theory under which Platinum, in buying non-asbestos assets for value in a non-merger, could have inherited asbestos related liability; indeed, the trial judge determined that UNR's (Rohn's predecessor) asbestos liability was permanently discharged and enjoined so no liability would pass to Platinum.[20]

Citing to Restatement § 228, the Delaware Supreme Court reversed. Even though the termination provision expressly invoked Platinum's "good faith," while not using the word "satisfaction" at all, the Delaware Supreme Court held that the clause was akin to a satisfaction clause, and thus governed by the common law as to such provisions. Based on those principles, the Supreme Court drew the border line between objective and subjective review of such provisions in crystal clear terms:

[T]he key question in this case, as derived from Section 288 and New York case law, is whether it is possible to determine objectively whether a reasonable person in Platinum's position would have been satisfied by the protections against asbestos related liability, as distinguished from whether Platinum itself in good faith concluded the protections were unsatisfactory. The trial court's determination that there was no basis in law or fact for terminating the Agreement demonstrates self-evidently that this question is, in fact, answerable. Here, there were objective standards to guide the trial judge, and based on those standards, she concluded that Platinum acted unreasonably.

> Because there are objective standards to guide the court's assessment of the reasonableness of Platinum's termination, we hold that the trial judge erred in applying a subjective good faith analysis to determine that Platinum properly terminated the agreement. We find that New York law demands that the termination of a contract in reliance upon a satisfaction clause be objectively reasonable where there are, as here, objective standards to guide the court.[21]

The notion that "answerable" questions should be answered objectively should serve as a guide for contract draftsmen, particularly in the merger and acquisitions field, where courts are loathe to view the exercise of contractual discretion in anything other than monetary terms.

The outcome in reinforces that point. In reversing, the Delaware Supreme Court directed the entry of judgment in Rohn's favor, and remanded the case to the trial court for computation of damages.[22] On remand, Rohn was awarded damages of $20.4 million.[23]

Lessons from Rohn v. Platinum

The Delaware Supreme Court's decision in Rohn v. Platinum was no anomaly. Since then, the law of satisfaction clauses continues to trip up seemingly sophisticated parties in the M&A context.

In UBS Secs. LLC v. Finish Line Inc., for example, Chief Judge Preska of the U.S. District Court for the Southern District of New York denied a motion by UBS to dismiss claims that it breached its obligation to finance the parties' merger, where its commitment letter expressly provided that: "UBS shall have reviewed, and be satisfied with, the final structure of the Acquisition and the terms and conditions of the Acquisition Agreement …"[24]

UBS argued that it would not be satisfied with any possible changes to the parties' acquisition agreement, and thus it should be allowed to withdraw its financing commitment. Judge Preska disagreed, noting that: "these clauses are interpreted to apply an objective standard of reasonableness to the 'satisfaction' determination. … Moreover, UBS's dissatisfaction 'must be with the circumstance and not with the underlying bargain.'"[25]

The lesson here should be clear. Clever draftsmanship is no panacea to the burden of fulfilling one's contractual obligations. A satisfaction clause, while potentially transforming an otherwise illusory contract into an enforceable one, carries with it concomitant duties. And more often than not, a judge or jury will adjudicate those duties under a "reasonable person" standard that does not afford the degree of discretion the contract's drafter may have intended.

Particularly in the commercial context, and almost always when the commerce in question involves sophisticated parties such as those found in an M&A transaction, objectivity will prevail. The engine of commerce requires rules and reason, not whim and caprice, and the courts tend to see themselves as the guardians of this regime. The answer, then, is not one of sound drafting but rather of measured advice. A client should be made to understand the seriousness of the contractual bond and only proceed if its determination to do so is absolute and unwavering. Anything short of that can turn into a very expensive mistake.

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[1] Brooklyn v. Brooklyn C. R. Co., 47 N.Y. 475, 479 (1872).

[2] Morin Bldg. Prods. Co. v. Baystone Constr., Inc., 717 F.2d 413, 415 (7th Cir. 1983) (applying Indiana law); see also 13 Williston on Contracts, § 38:24 (4th ed. 2000).

[3] 717 F.2d at 415 (emphasis added).

[4] Alper Blouse Co. v. E. E. Connor & Co., 127 N.E.2d 813, 815 (1955) (citations omitted).

[5] See, e.g., Larry Snyder & Co. v. Miller, 648 F.3d 1156, 1160-61 (10th Cir. 2011) (contract to install utility trenches); Younglove Constr., LLC v. Psd Dev., LLC, 2010 U.S. Dist. Lexis 92334, *12 (N.D. Ohio Sept. 3, 2010) (contract to build animal feed facility); Westby v. Schmidt, 779 N.W.2d 681, 687 (N.D. 2010) (home construction); Intra-American Found. & Drilling Co. v. R.M. Harris Co., 2009 Cal. App. Unpub. Lexis 310, *20 (Cal. App. 1st Dist. Jan. 14, 2009) (bridge construction); Pearse Assocs., LLC v. Perry, 960 A.2d 1166, 1171 (Maine 2008) (real estate transaction); Energen Res. Corp. v. Golden Oil Co. (In re Golden Oil Co.), 2008 U.S. App. Lexis 1393, ** 8-9 (5th Cir. 2008) (escrow agreement for future plugging costs of oil wells).

[6] See 42 East, LLC v. D.R. Horton, Inc., 2012 N.C. App. Lexis 201, *25 (N.C. Ct. App. Feb. 7, 2012).

[7] See Sweet v. TCI MS, Inc., 47 So. 3d 89, 92 (Miss. 2010).

[8] See State v. Brooks, 2011 Ohio 3722, **27-30 (Ohio Ct. App., Greene County July 29, 2011); Scarborough v. State, 945 A.2d 1103, 1112 (Del. 2008); United States v. Lewis, 2007 U.S. App. Lexis 1844, *3 (2d Cir. 2007).

[9] Cara L. Krach v. Lakeside Transp. Co., 2010 U.S. Dist. Lexis 2672 (N.D. Ohio Jan. 12, 2010).

[10] See Thommeny v. Paramount Pictures Corp., 2011 U.S. Dist. Lexis 80291, *10 (C.D. Cal. July 13, 2011).

[11] N.Y. U.C.C. § 2-103(1)(b) (emphasis added).

[12] 341 F.3d 149, 153 (2d Cir. 2003) (emphasis added, applying New York law).

[13] C.A. No. 03C-04-134-SCD (Del. Super. Ct., New Castle Cnty.).

[14] Rohn Indus., Inc. v. Platinum Equity LLC, 911 A.2d 379, 381 (Del. Super. Ct., 2005).

[15] In re UNR Indus., 20 F.3d 766, 770 (7th Cir. 1994).

[16] 911 A.2d at 381.

[17] Id.

[18] Id.

[19] Id. (emphasis added).

[20] Id. at 382-83.

[21] Id. at 385-86 (emphasis added).

[22] Id. at 385.

[23] See C.A. No. 03C-04-134-SCD (Del. Super. Ct., New Castle Cnty.), Final Judgment entered July 25, 2007.

[24] 2008 U.S. Dist. Lexis 18183, *14 (S.D.N.Y. Feb. 22, 2008) (emphasis added).

[25] Id. **19-20 (citing Restatement (Second) of Contracts § 228 cmt. a) (emphasis added).

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