What You Don’t Say Can Hurt You: Delaware’s Forthright Negotiator Principle

In United Rentals, Inc. v. RAM Holdings, Inc., the Delaware Court of Chancery used the forthright negotiator principle in interpreting an otherwise ambiguous contractual provision. The Court applied this principle in denying the plaintiff’s petition for specific performance of a merger agreement. Those involved in the negotiation of contractual provisions should take note; in certain circumstances the forthright negotiator principle may create an affirmative duty on the part of deal negotiators to clarify potentially ambiguous terms.

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On December 21, 2007, the Delaware Court of Chancery issued an opinion remarkable not only for the speed in which it was produced, but also for the stark lessons it provides for practitioners. In United Rentals, Inc. v. RAM Holdings, Inc., the Court denied the plaintiff’s petition for specific performance of a merger agreement it had entered into with affiliates of Cerberus Partners, L.P. In denying this request, the Court used a long-standing but rarely invoked principle of Delaware contract law: the forthright negotiator principle. This principle provides that a court may accept one party’s objectively reasonable, subjective understanding of an otherwise ambiguous contractual provision as controlling, so long as that understanding has been “objectively manifested” in such a way that the other party knows or should know of that understanding. The Court’s discussion of the principle, and especially the principle’s application to the world of deal negotiation, provides a powerful lesson for those leading contractual negotiations.

The Objective Theory of Contract Interpretation

To understand the implications of the United Rentals decision fully, a brief discussion of Delaware’s law of contract interpretation is helpful. When construing the terms of a written contract, a Delaware court’s primary goal is to give voice to the intent of the parties. To achieve this goal, the court’s “ultimate guide” is to “attempt to fulfill, to the extent possible, the reasonable shared expectations of the parties at the time they contracted.” Thus, the court “stand[s] in the shoes of an objectively reasonable third-party observer” and ascertains whether the language of the contract is clear.

The court’s role in implementing this so-called objective theory of contract interpretation can be broken up into several stages. The first stage consists of what is commonly referred to as the “clear
meaning rule.” Because the agreement itself likely is the most objective manifestation of the parties’ intent, “where the parties have created an unambiguous integrated written statement of their contract, the language of that contract (not as subjectively understood by either party but) as understood by a hypothetical third party will control.” As such, when the unambiguous terms of a contract lead to only one reasonable interpretation, the court will look no further; the clear meaning of the contract will prevail.

If, after analyzing the contract under the clear meaning rule, the court determines that the agreement is ambiguous, it will then turn to the second stage of contract interpretation: a consideration of the evidence surrounding each side’s decision to enter into the contract. The court will examine this extrinsic evidence in an attempt to determine whether the parties agreed on a single, objectively reasonable meaning for the term in question. The evidence the court will consider may include “statements made during the course of the negotiation, courses of prior dealings between the parties, and practices in the relevant trade or industry.” This aspect of contract interpretation is frequently called the “parol evidence rule.”

The Forthright Negotiator Principle

In many instances, the contract will either be found to be unambiguous or the extrinsic evidence will lead the court to conclude that the parties shared a single interpretation of the provision in question. When this is not the case, the forthright negotiator principle comes into play. First articulated by Chancellor Allen in U.S. West, Inc. v. Time Warner, Inc., the forthright negotiator principle was not a new principle of contract interpretation. Rather, it was a user-friendly reformulation of principles set forth in (among other places) the Restatement (Second) of Contracts.

In U.S. West, Chancellor Allen first reiterated the guiding principles of Delaware law on contract interpretation, including the clear meaning rule and the parol evidence rule. He then posed the following query: “If, given the nature of the extrinsic evidence, such [a single objectively reasonable meaning] is not quite so obvious (as of course will often be the case), what is the process through which a court determines the existence and scope of legal rights and duties where contract language is ambiguous?” He answered this question by propounding the forthright negotiator principle:

The following third principle of contract law structures that inquiry: Only an objectively reasonable interpretation that is in fact held by one side of the negotiation and which the other side knew or had reason to know that the first party held can be enforced as a contractual duty. This principle is capable of resolving disputes arising from ambiguous contract language because it is logically impossible for a contracting party, operating in good faith, both to have a subjective interpretation of ambiguous language different from that of her counterparty and to know of her counterparty’s differing interpretation. Thus, while the subjective understanding of a contracting party is not ordinarily a relevant datum in determining the existence and scope of contractual obligation (such obligations being determined under an “objective” standard), where ambiguity in contract language is not easily resolvable by extrinsic evidence, it may be necessary for the court, in considering alternative reasonable interpretations of contract language, to resort to evidence of what one side in fact believed the obligation to be, coupled with evidence that the other party knew or should have known of such belief. This last principle of contract construction might be called the forthright negotiator principle.

Chancellor Allen’s explanation of the principle makes clear that a contract term does not necessarily fail merely because it is ambiguous and the extrinsic evidence does not lead the court to conclude that the parties had agreed on a single, objectively reasonable meaning. In this situation, principles of good faith dictate that if (1) one party to a contract makes its understanding of an ambiguous contract provision known, and (2) the other party, after being made aware of this meaning (or after the circumstances are such that the party should be aware of this meaning), fails to reveal its own, contrary interpretation, then (3) the first parties’ meaning will control.
Between Chancellor Allen’s 1996 decision in *U.S. West* and Chancellor Chandler’s 2007 *United Rentals* decision, Delaware courts have had only infrequent opportunities to discuss this principle. Indeed, only one other decision in this time period refers to the principle by name. The relative infrequency of its use belies its importance; the Court’s application of the forthright negotiator principle to the facts in the *United Rentals* case provides a glaring reminder of the extent to which the application of the principle imposes an affirmative duty on deal negotiators to clarify potentially ambiguous deal terms. It should provide ample encouragement to contracting parties to address the “hard issues” during the negotiation process.

**A Failure in Negotiation: the *United Rentals* Decision**

On July 22, 2007, URI and two shell entities created by Cerberus Capital Management—RAM Holdings, Inc. and RAM Acquisition Corp.—entered into a merger agreement whereby URI would merge with RAM Acquisition Corp. and survive as a direct, wholly owned subsidiary of RAM Holdings, Inc. As consideration, the stockholders of URI were to receive $34.50 in cash for each share of URI common stock. The total transaction value was approximately $7 billion, including the repayment or refinancing of URI’s existing debt.

Subsequently, in a letter dated November 14, 2007, RAM informed URI that it no longer intended to complete the merger on the economic terms set forth in the merger agreement, and offered to either renegotiate the deal or pay a $100 million reverse termination fee called for by the merger agreement—a fee RAM believed was URI’s sole recourse in the event of a breach of the merger agreement by RAM. URI, in turn, declined RAM’s offer to renegotiate or accept the termination fee, and instead filed a lawsuit on November 19 in the Delaware Court of Chancery seeking specific performance of the merger agreement.

The dispute between URI and RAM centered on whether the merger agreement limited URI’s remedy in the event of a breach of the merger agreement by RAM to the $100 million reverse termination fee, or whether URI could seek specific performance of the merger agreement. Two provisions of the merger agreement were potentially relevant. URI posited that Section 9.10 set forth its right to seek specific performance of the merger agreement’s terms. The language of Section 9.10 provided that URI could “enforce specifically the terms and provisions of this Agreement … [if] the Financing … is available to be drawn down by [RAM Holdings] … but is not so drawn down solely as a result of [the RAM Entities] refusing to do so in breach of this agreement.”

However, as RAM would later point out, Section 9.10 continued by stating that “[t]he provisions of this Section 9.10 shall be subject in all respects to Section 8.2(e) hereof, which Section shall govern the rights and obligations of the parties hereto.” Article VIII of the merger agreement, of which Section 8.2(e) was a part, provided limited circumstances in which either URI or RAM could terminate the agreement and receive a $100 million termination fee. In addition, Section 8.2(e) provided, in relevant part, that “in no event shall the Company seek equitable relief or seek to recover any money damages in excess of [the termination fee]” from the RAM Entities.

The extrinsic evidence revealed a “deeply flawed negotiation in which both sides failed to clearly and consistently communicate their client’s positions.” The Court held that, on the subject of the availability of specific performance, the merger agreement was “hopelessly conflicted.” Moreover, the extrinsic evidence revealed a “deeply flawed negotiation in which both sides failed to clearly and consistently communicate their client’s positions.” Because the evidence did not indicate that a single, shared understanding of the provisions at issue had been reached, the Court turned to the forthright negotiator principle.

Chancellor Chandler’s description of the principle closely tracked Chancellor Allen’s formulation: “the forthright negotiator principle provides that, in cases where the extrinsic evidence does not lead to a
single, commonly held understanding of a contract’s meaning, a court may consider the subjective understanding of one party that has been objectively manifested and is known or should be known by the other party.” 36 Relying on this principle, the Court made two findings. First, “even if [URI] believed the Agreement preserved a right to specific performance, its attorney ... categorically failed to communicate that understanding to [RAM] during the latter part of the negotiations.” 37 In addition, although RAM could have “easily avoided this entire dispute by striking Section 9.10(b) from the Agreement, ... its attorney did communicate to URI his understanding that the Agreement precluded any specific performance rights.” 38 Thus, the Court concluded:

Even if URI’s deal attorneys did not affirmatively and explicitly agree to the limitation on specific performance as several witnesses allege they did on multiple occasions, no testimony at trial rebutted the inference that I must reasonably draw from the evidence: by July 22, 2007, URI knew or should have known what Cerberus’s understanding of the Merger Agreement was, and if URI disagreed with that understanding, it had an affirmative duty to clarify its position in the face of an ambiguous contract with glaringly conflicting provisions. 39

Because it failed to meet its burden of demonstrating that the common understanding of the parties permitted specific performance of the merger agreement, URI’s petition was denied. 40

The Lessons of United Rentals

The United Rentals decision contains many important lessons and should be read by deal negotiators and litigators alike.

First: While an obvious point, it is one that bears repeating: If at all possible, deal with the hard issues up front. The litigation in United Rentals may have been avoided had the issue of the availability of specific performance been resolved in the merger agreement in an unambiguous manner.

Second: If, as is sometimes the case, some ambiguity in certain provisions is necessary to strike a deal,41 keep the forthright negotiator principle firmly in mind. If the other side demonstrates an understanding of a provision that is inconsistent with your own understanding, relying on the ambiguous nature of the provision to support your interpretation can be a risky proposition—you may have an affirmative duty to make your understanding clearly known. United Rentals emphasizes that an attorney’s failure to comply with this duty can have serious consequences.

Third: Avoid relying on “subject to” language to write provisions out of an agreement. Attorneys for RAM argued that because Section 9.10 contained language making it “subject to” Section 8.2(e), the merger agreement itself set up a clear hierarchy between the provisions and Section 8.2(e) should control. While the Court found this interpretation to be a “reasonable” one, it was not sufficient to override URI’s contradictory interpretation.42 If, as RAM contended, an agreement on the specific performance issue had been reached, it would have been preferable if Section 9.10(b) had been stricken. 43

Chancellor Chandler’s opinion in United Rentals provides an insider’s look into the world of deal negotiation. It highlights the difficulties inherent in the attempt to create a complex legal instrument within the constraints imposed by business considerations. Most importantly, this opinion provides a stark lesson on the importance of full and frank communication between parties on both sides of contract negotiations. As the Court’s application of the forthright negotiator principle makes clear, when presented with an interpretation of an ambiguous contract provision that differs from their own, deal negotiators may have an affirmative duty to make their disagreement (and their contrary interpretation) known. In such a situation, it’s what you don’t say that can hurt you.

NOTES

1. Chancellor Chandler’s 67-page memorandum opinion was issued less than 48 hours after the two-day trial was completed.
3. See id. at *1 (“[L]ike the three heads of the mythological Cerberus, the private equity firm of the same name presents three substantial challenges to plaintiff’s case: (1) the language of the Merger Agreement, (2) evidence
of the negotiations between the parties, and (3) a doctrine of contract interpretation known as the forthright negotiator principle.”).
4. Id. at *19.
5. This discussion is provided in order to place the forthright negotiator principle in its proper context. A full analysis of Delaware’s law of contract interpretation is beyond the scope of this article.
6. See Watkins v. Beatrice Cos., 560 A.2d 1016, 1021 (Del. 1989) (“The correct interpretation of a contract primarily focuses upon the search for the ‘common meaning of the parties, not a meaning imposed on them by law.”’ (citations omitted)).
9. In Seidensticker v. Gasparilla Inn, Inc., 2007 WL 4054473, at *3 (Del. Ch. Nov. 8, 2007), the Court of Chancery made clear that Delaware still adheres to the objective theory of contract interpretation:
   The Supreme Court’s recent decision in Approvia S’holder Litig Co. v. EV3, Inc. does not set forth a new or different standard .... Where a contract term is objectively clear and there is only one “reasonable interpretation,” it is well within the province of this Court to rule as a matter of law. The Supreme Court may have quoted language suggesting a subjective theory of contracts from Klair v. Reese, but Approvia does not rely on a subjective theory to reach its holding. Because of this, and because the Supreme Court has ... expressly “disapproved” of the “overbroad” language of Klair, I cannot determine that Approvia alters Delaware’s stalwart and longstanding adherence to an objective theory of contracts.
   Id. (citations omitted).
11. Id.
12. See Eagle Indus., Inc. v. DeviBliss Health Care, Inc., 702 A.2d 1228, 1232 (Del. 1997) (“If a contract is unambiguous, extrinsic evidence may not be used to interpret the intent of the parties, to vary the terms of the contract or to create an ambiguity. But when there is uncertainty in the meaning and application of contract language, the reviewing court must consider the evidence offered in order to arrive at a proper interpretation of contractual terms.” (citation omitted)); see also Lillis v. AT&T Corp., 2007 WL 2110587, at *16 (Del. Ch. July 20, 2007) (“Where, as here, ‘there is uncertainty in the meaning and application of the terms of the contract’ the court ‘will consider testimony pertaining to antecedent agreements, communications and other factors which bear on the proper interpretation of the contract.’” (citations omitted)).
14. Id.
15. Id.
17. See, e.g., Bell Atl. Meridian Sys. v. Octel Commc’ns Corp., 1995 WL 707916, at *11 (Del. Ch. Nov. 28, 1995) (holding that despite evidence indicating one party’s expansive interpretation of a contract provision, that interpretation would not control the meaning of the contract absent evidence that the other party knew or had reason to know of that interpretation).
18. Section 201 of the Restatement (Second) of Contracts, entitled “Whose Meaning Prevails,” provides in relevant part:
   (2) Where the parties have attached different meanings to a promise or agreement or a term thereof, it is interpreted in accordance with the meaning attached by one of them if at the time the agreement was made
   (a) that party did not know of any different meaning attached by the other, and the other knew the meaning attached by the first party; or
   (b) that party had no reason to know of any different meaning attached by the other, and the other had reason to know the meaning attached by the first party.
Restatement (Second) of Contracts § 201(2) (1981); see also Corbin on Contracts § 537 (1960).
20. Id. at *10 (citation omitted).
21. Id. at *10–11 (citations omitted).
22. See Comrie v. Enterasys Networks, Inc., 837 A.2d 1 (Del. Ch. 2003). However, other decisions apply the principles enunciated in U.S. West without utilizing Chancellor Allen’s nomenclature. See, e.g., DCV Holdings, Inc. v. ConAgra, Inc., 2005 WL 698133, at *11 (Del. Super. March 24, 2005), aff’d, 889 A.2d 954 (Del. 2005) (“A contract will be construed against a party who maintains its own interpretation of an agreement and fails to inform the other party of that interpretation.” (citation omitted)). Moreover, in In re IBP, Inc., S’holders Litig., 789 A.2d 14 (Del. Ch. 2001), the Court of Chancery, applying New York contract law, used the concept of a “forthright negotiator” to justify its eventual holding. See id. at 61–62 (“Reasonable and forthright negotiators for Tyson would—and I find did—understand Hagen as expressing her view that the Schedule ensured that Tyson was accepting the fully disclosed risk that IBP would recognize additional charges .... Therefore, it is reasonable to infer that Tyson’s negotiators believed that these charges had been carved out entirely by [the agreement].”).
24. Id.
25. Id. Cerberus Capital Management was not a party to the merger agreement or the eventual lawsuit.
26. Id. at *12–13. Because the merger agreement was between URI and two shell entities, URI negotiated for and received a Limited Guarantee from Cerberus Partners, whereby Cerberus agreed to guarantee certain payment obligations of the RAM Entities, up to a maximum amount of $100 million and certain incidental solicitation expenses. Id. at *2.
27. Id. at *13. When news of RAM’s letter was reported in the press on November 14, URI’s shares fell by more than 30 percent to $23.50, or $10.29 less than the opening price. Id.
28. Id. at *3–4.
29. Id. at *3.
30. Id.
31. Id.
32. Id. at *3-4. While one might initially wonder why URI did not name Cerberus as a defendant to the litigation—especially considering the fact that the RAM Entities were mere shells—the relevant deal documents quite clearly foreclosed that possibility. First, Cerberus was not a party to the merger agreement. Id. at *1. Second, the Limited Guarantee explicitly provided that recourse against Cerberus Partners under the Limited Guarantee would be the “sole and exclusive remedy” of URI with respect to any liabilities arising under the merger agreement. Id. at *14. Finally, the equity commitment letter, through which a Cerberus entity agreed to provide approximately $1.5 billion in equity for the proposed merger, explicitly disclaimed URI’s third-party beneficiary status. Id. at *13. Thus, as Chancellor Chandler stated, “[t]hough URI may harbor dreams of compelling performance by Cerberus Partners and CCM, that is not what they seek in this action.” Id. at *14.
33. Id. at *19.
34. Id.
35. See id. at *19–20
36. Id. at *19 (citation omitted).
37. Id.
38. Id.
39. Id. at *25; see also In re IBP, 789 A.2d at 61 (applying New York contract law and holding that because “forthright negotiators” for Tyson would have understood IBP’s position on the issue, “[t]o the extent that the Tyson negotiators had a question whether Hagen’s carve-out was intended to permit IBP to recognize these additional charges resulting from past accounting practices by way of a restatement of the Warranted Financials, they should have spoken up. The current, hairsplitting interpretation that Tyson advances was never voiced to Hagen at the time, and I do not think that the Tyson negotiators embraced that interpretation at the time”).
41. The court in United Rentals recognized that ambiguity was sometimes a necessary component of contract negotiations: “The law of contracts, however, does not require parties to choose optimally clear language; in fact, parties often riddle their agreements with a certain amount of ambiguity in order to reach a compromise.” United Rentals, 2007 WL 4591849, at *25 (citing Richard A. Posner, “The Law and Economics of Contract Interpretation,” 83 Tex. L. Rev. 1581, 1583 (2005) (“Deliberate ambiguity may be a necessary condition of making the contract; the parties may be unable to agree on certain points yet be content to take their chances on being able to resolve them, with or without judicial intervention, should the need arise.”)).
42. See United Rentals, 2007 WL 4591849, at *17-18.
43. See id. at *25 (“As with may contract disputes, hindsight affords the Court a perspective from which it is clear that this case could have been avoided: if Cerberus had simply deleted section 9.10(b), the contract would not be ambiguous, and URI would not have filed this suit.”).