June 29, 2016

# Delaware Court of Chancery Holds That Outside Counsel's Refusal to Render Tax Opinion Required for Closing of Merger Was in Good Faith and Permits Termination of Merger Agreement

In *The Williams Companies, Inc.* v. *Energy Transfer Equity, L.P.*, *et al.*, the Delaware Court of Chancery held that an acquirer in a merger did not fail to use "commercially reasonable efforts" to obtain a tax opinion from its tax counsel, receipt of which was a closing condition, where, as a factual matter, the Court concluded that acquirer tax counsel's refusal to render the opinion was in good faith. The Court therefore permitted the acquirer to terminate the merger agreement by an outside date if the acquirer could not obtain the tax opinion. The acquirer in fact terminated the merger agreement on June 29, 2016. Although the Court's decision has received great attention, the outcome rested heavily on the unique facts of the case at hand, including the precipitous drop in energy prices after the signing of the merger agreement and the Court's credibility findings with respect to trial witnesses.

For those who draft transactional documents, the decision serves as a reminder that Delaware courts will not substitute their judgment for that of tax counsel specified in the contract, and, absent evidence of affirmative misconduct by a party or bad faith by counsel, may be unwilling to find a breach of a covenant to use "commercially reasonable efforts" to obtain such an opinion. These types of tax-opinion conditions are typical in tax-deferred transactions, and parties that desire additional protection or flexibility with respect to these closing conditions will need to bargain for it.

## Background

In September 2015, The Williams Companies, Inc. ("Williams") and Energy Transfer Equity, L.P. ("ETE") entered into an agreement pursuant to which ETE would acquire Williams. To accommodate Williams' desire for its stockholders to be able to continue to hold publicly-traded equity of a corporation for U.S. federal income tax purposes and to receive cash consideration, the acquisition involved a series of transactions described below.

*Transaction Structure.* As contemplated, ETE would create Energy Transfer Corp LP ("ETC"), a corporation for U.S. federal income tax purposes, and then Williams would merge into ETC, which would be the surviving entity. In exchange, Williams stockholders would receive approximately 81% of outstanding ETC units, based on a fixed exchange ratio, approximately $6 billion in cash and certain contingent consideration rights ("CCRs"). In connection with the merger, ETE would supply the $6



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billion in cash in exchange for ETC issuing a fixed number of units (the "Hook Stock") representing approximately 19% of the equity of ETC and CCRs (the "Cash Transaction"). Immediately following the merger, ETC would contribute Williams' assets to ETE in exchange for a fixed number of newly issued Class E partnership units (the "Class E Units") of ETE (the "Contribution").

*Section 721 Opinion and the Intended Tax-Free Contribution*. The tax-free treatment of the Contribution was important to the parties due to an apparently substantial built-in gain in the Williams' assets. Therefore, in the merger agreement, the parties agreed that a condition precedent to both of their obligations to consummate the proposed acquisition was the issuance of an opinion by ETE's tax counsel that, as of closing, the Contribution "should" be treated as a tax-free exchange under Section 721(a) of the Internal Revenue Code (the "721 Opinion"), which provides generally for the non-recognition of gain in connection with a transfer of property to a partnership for U.S. federal income tax purposes. Both parties also represented that they had not taken or agreed to take any action, and did not know of any fact, that would reasonably be expected to prevent the Contribution from qualifying under Section 721(a) (the "721 Representation") and covenanted to use "commercially reasonable efforts" to secure the required 721 Opinion from ETE's tax counsel. Finally, the merger agreement provided that if the acquisition did not occur by a specified "Outside Date," then either party could terminate the merger agreement without penalty, so long as that party's failure to perform one of its obligations under the agreement was not the principal cause of the failure of the proposed acquisition to be consummated by the Outside Date.

*Drop in ETE Value*. Due to the precipitous decline in energy prices, by January 2016, the proposed acquisition was highly unattractive to ETE, and ETE sought to terminate or restructure the deal. Against this backdrop, in late March 2016, ETE's Head of Tax, while ostensibly considering other actions ETE could take to mitigate the impact of the distress in the energy sector, claimed to have discovered (for the first time) a fundamental and fully-disclosed aspect of the proposed acquisition. According to the Head of Tax, he had originally thought that the cash exchange for the Hook Stock in the Cash Transaction would be for a *floating* number of ETC units, but he now realized it was for a *fixed* number of ETC units. Because of the decline in ETE's unit price, ETE now stood to receive Hook Stock that was significantly less valuable than the $6 billion it was obligated to pay. ETE's Head of Tax testified that he feared that the Internal Revenue Service could attribute the excess cash received in the Cash Transaction to the Contribution, which would trigger taxable gain on the asset transfer in a disguised sale for tax purposes.

*ETE's Tax Counsel's Analysis*. Thereafter, ETE's Head of Tax contacted ETE's tax counsel to determine if the potential excess cash issue could affect its 721 Opinion. Before this conversation, ETE's tax counsel had been prepared to deliver the 721 Opinion and had not previously considered the effects of movements in the ETE unit price. After devoting over 1,000 hours of attorney time to analyzing the issue, however, ETE's tax counsel eventually determined that the complex interaction between the Cash Transaction and the Contribution did indeed have significant tax implications, and ultimately informed ETE that it could not provide the 721 Opinion absent a recovery in the value of the Hook Stock. Williams' M&A counsel

proposed two potential solutions to the issue, but ETE's tax counsel concluded that neither proposal fixed the problem.

*Other Analysis of the Tax Issue*. ETE's Head of Tax also sought tax advice on the issue from a former colleague at a second law firm. The second law firm concluded that it could not issue the 721 Opinion if asked to do so, although for different reasons than ETE's tax counsel. At trial, ETE's expert opined that, for reasons similar to that of ETE's tax counsel, a "should" opinion was not appropriate. Williams' own special tax counsel "looked at the issue and initially stated that it would be 'difficult to get to should,' but eventually stated that it could issue a 'weak-should' opinion." Williams' M&A counsel, as well as Williams' tax expert, asserted that even with the decline in the ETE unit prices tax authorities would respect the transaction as structured, and that the Contribution thus "should" be treated as tax free as the parties originally intended.

## Analysis

With the Outside Date approaching, Williams sued ETE in the Court of Chancery asserting, among other things, that ETE breached the merger agreement by failing to use "commercially reasonable efforts" to obtain the 721 Opinion or by breaching the 721 Representation. Williams sought to enjoin ETE from relying on the failure of ETE's tax counsel to deliver the 721 Opinion as a basis to terminate the agreement. At trial, Williams also alleged that ETE's tax counsel acted at the direction of ETE and reached a conclusion regarding the 721 Opinion that no reasonable tax attorney could reach (*i.e.*, ETE's tax counsel acted in bad faith). ETE countered that it had not breached the efforts provision or the 721 Representation, that it was not required to consider Williams' alternative proposals and that it was entitled to terminate the agreement if its tax counsel was still unable to deliver the 721 Opinion on the Outside Date. After a two day trial, the Court, approaching the case with a "skeptical eye" because of ETE's clear desire to walk away from the deal, held as follows:

- *The parties contracted for ETE's tax counsel to provide the 721 Opinion, and, absent bad faith on the part of ETE's tax counsel, the Court will respect their bargain and ETE's tax counsel's opinion*. The Court first noted that, under the agreement, the parties had bargained for a subjective, good-faith determination from ETE's tax counsel regarding whether the Contribution "should" qualify as tax free under Section 721(a). The Court posited that the parties could have contracted for some other mechanism or standard, but instead assigned that responsibility to ETE's tax counsel. As such, the Court explained that it was not appropriate for it to substitute its own judgment for that of ETE's tax counsel's, and its sole role was to determine whether ETE's tax counsel's refusal to issue the 721 Opinion was made in good faith, "that is, based on [its] independent expertise as applied to the facts of the transaction."

- *ETE's tax counsel did not act in bad faith*. Despite Williams' allegations otherwise, the Court concluded that ETE's tax counsel acted in good faith and was not influenced by the concededly

manifest interests of ETE. The Court credited testimony that ETE's tax counsel did not realize the implications of the transaction structure on its ability to issue the 721 Opinion until April 2016. Further, there was no evidence of any explicit or implicit direction by ETE to its tax counsel to pursue a particular outcome. The Court also noted that the range of opinions presented by the various tax practitioners at trial demonstrated the closeness of the issue and the unusual nature of the transaction, not that ETE's tax counsel's conclusion was one that no reasonable tax attorney could reach.

- *ETE did not breach its obligation to use "commercially reasonable efforts" to obtain the 721 Opinion.* The Court found that by agreeing to make "commercially reasonable efforts" to obtain the 721 Opinion, ETE "bound itself to do those things objectively reasonable to produce the desired 721 Opinion, in the context of the agreement between the parties." The Court held that ETE's identification of the tax issue for its tax counsel's review did not violate the "commercially reasonable efforts" clause, and that, whatever ETE's motivations, Williams could point to no reasonable efforts that ETE could take to consummate the acquisition and convince ETE's tax counsel to deliver the 721 Opinion. There was also no evidence that ETE had "manipulated the knowledge or ability of [its tax counsel] to render the 721 Opinion, or failed to fully inform [its tax counsel], or do anything else . . . to obstruct [its tax counsel's] issuance of the condition-precedent 721 Opinion, or that had a material effect on [its tax counsel's] decision."

- *The absence of affirmative action by ETE to frustrate the condition precedent distinguished the case from prior rulings.* The Court distinguished the case at hand from prior cases where the Court had found that a party had breached an efforts clause. The Court noted that in those cases there was evidence of affirmative acts taken by the party to frustrate the condition precedent and that had the "record here reflected affirmative acts by [ETE] to coerce or mislead [its tax counsel], by which actions it prevented issuance of the 721 Opinion, . . . the outcome here would likely be different."

- *ETE did not breach the 721 Representation.* The Court explained that "[t]he purpose of such a provision is that all sides can be fully informed as of the time the agreement is reached." The Court ruled that ETE's tax counsel's legal analysis, a theory of tax liability, was not a "fact" requiring disclosure under the merger agreement and that even if it were a fact, nothing in the record indicated that the legal theory had been known or developed by ETE or its tax counsel at the time of signing.

Williams has appealed the Court of Chancery's decision to the Delaware Supreme Court on a non-expedited basis. ETE's tax counsel did not deliver the 721 Opinion by the Outside Date, and ETE terminated the merger agreement on June 29, 2016.

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This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

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