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Delaware Supreme Court Affirms Decision Permitting Merger Termination Based on Failure to Satisfy Tax Opinion Covenant

In a 4-1 split decision in *The Williams Cos., Inc.* v. *Energy Transfer Equity, L.P., et al.*, the Delaware Supreme Court affirmed the Court of Chancery's decision permitting termination of a merger agreement by the acquirer based on the failure of the acquirer to obtain a tax opinion from its counsel, the receipt of which was a condition precedent to the closing of the merger. The Supreme Court held that even though the Court of Chancery did not properly analyze whether the acquirer met its covenants to use "commercially reasonable efforts" to obtain the tax opinion and "reasonable best efforts" to consummate the transaction, the acquirer had met its burden of proving that any alleged breach did not materially contribute to the failure to obtain the tax opinion. In his dissent, Chief Justice Strine argued that the evidence suggested that the acquirer failed to fulfill its covenant to use commercially reasonable efforts to obtain the tax opinion.

Background

The case involved Energy Transfer Equity, L.P.'s ("ETE") acquisition of the assets of The Williams Companies, Inc. ("Williams") in a two-step transaction. In the first step, Williams would merge into Energy Transfer Corp LP ("ETC"), a new vehicle created by ETE and intended to be treated as a corporation for U.S. federal income tax purposes. Williams's stockholders would receive approximately $6 billion in cash (transferred to ETC by ETE) and 81% of ETC's outstanding units in exchange for their Williams stock, and ETE would receive 19% of ETC's outstanding units in exchange for its $6 billion in cash. In the second step, ETC would transfer Williams's assets to ETE in exchange for newly issued ETE Class E partnership units equal in number to the ETC units. Importantly, the merger was conditioned on receipt of an opinion by ETE's outside tax counsel that the second step "should" be treated as a tax-free exchange of a partnership interest for assets under Section 721(a) of the Internal Revenue Code (the "721 opinion"). The merger agreement also required the parties to use "commercially reasonable efforts" to obtain the 721 opinion and "reasonable best efforts" to consummate the transaction.

After the parties executed the merger agreement, the energy market declined sharply, causing a significant decline in the value of the assets of Williams and ETE, and the transaction became undesirable to ETE. The decline in value of the assets also led ETE's Head of Tax to question whether the IRS might view the second step as a taxable event due to the fixed number of ETC units to be issued for ETE's approximately $6 million in cash. He raised the issue with ETE's outside tax counsel, who ultimately determined that it was unable to render the 721 opinion. ETE sought the advice of a second outside tax counsel, who agreed that it too would be unable to issue a 721 opinion at a "should" level. Because the 721

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opinion was a condition precedent to the closing of the transaction, ETE planned to terminate the merger agreement and did so on July 29, 2016.

Williams sued to enjoin ETE from terminating the merger agreement, arguing, among other things, that ETE breached its covenants in the merger agreement by failing to use "commercially reasonable efforts" to obtain the 721 opinion and "reasonable best efforts" to consummate the transaction. Williams also argued that because ETE represented in the merger agreement that it knew of no facts that would reasonably be expected to prevent the second step of the transaction from qualifying under Section 721(a) of the Internal Revenue Code, ETE should be estopped from terminating the agreement.

Court of Chancery's Decision

In denying Williams's request to enjoin ETE from terminating the merger based on the failure to obtain the 721 opinion, the Court of Chancery made the following findings:

- Noting that the parties knowingly conditioned the merger on outside tax counsel's subjective opinion that the transaction "should" be tax-free under Section 721 and that counsel's refusal to render the decision went against its reputational interests, the Court of Chancery concluded that outside tax counsel acted independently and in good faith in determining that it could not issue the 721 opinion.

- Next, the Court of Chancery considered Williams's claim that ETE breached its covenant to use "commercially reasonable efforts" to obtain the 721 opinion. Relying on *Hexion Specialty Chemicals, Inc.* v. *Huntsman Corp.*, that essentially equated such efforts with good faith, the Court of Chancery concluded that ETE was "bound . . . to do those things objectively reasonable to produce the desired 721 Opinion." The court found that Williams could not point to any commercially reasonable efforts, or objectively reasonable actions, that ETE could have taken to secure the 721 opinion.

- Finally, the Court of Chancery addressed Williams's claim that ETE breached its representation that it knew of no "fact" at the time of signing that would reasonably be expected to prevent the second step of the transaction from qualifying under Section 721(a) of the Internal Revenue Code. It concluded that ETE did not breach this representation because 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.

For a more thorough discussion of the background of the case and the Court of Chancery's decision, click here.

Supreme Court Majority Opinion

On appeal, the Delaware Supreme Court, while ultimately affirming the Court of Chancery's decision, took issue with aspects of its analysis.

- First, the Supreme Court found that the Court of Chancery adopted an "unduly narrow view of *Hexion*" insofar as it focused on the absence of any evidence that ETE caused tax counsel to withhold the 721 opinion. The Supreme Court observed that "efforts" covenants like the ones involved here and in *Hexion* "impose obligations to take all reasonable steps to solve problems and consummate the transaction." Therefore, ETE had an affirmative obligation to take all reasonable steps to obtain the 721 opinion and otherwise complete the transaction and the Supreme Court noted that there was evidence in the record before the Court of Chancery from which it could have concluded that ETE breached its covenants. As such, the Supreme Court found that the Court of Chancery did not properly analyze whether ETE breached its covenants.

- Next, the Supreme Court rejected Williams's argument that the Court of Chancery should be reversed for improperly placing the burden of proving causation on Williams. The Supreme Court agreed with Williams that if the Court of Chancery had found that ETE breached its covenants, the burden of proof would shift to ETE to establish that its breach did not materially contribute to the failure of the transaction. Although the Supreme Court acknowledged that the Court of Chancery "appears to improperly place" the burden on Williams to show that ETE's alleged breach materially contributed to the failure of the transaction, the court noted that the Court of Chancery did not separately analyze the issue in the body of its opinion because it concluded that ETE did not breach its covenants. The Court of Chancery did, however, conclude in a footnote, "that the record is barren of any indication that the action or inaction of [ETE] (other than simply drawing [tax counsel's] attention to the problem) contributed materially to [tax counsel's] inability to issue the 721 Opinion." The Supreme Court concluded that this finding of fact was not clearly erroneous and declined to reverse the Court of Chancery as a result.

- Finally, the Supreme Court rejected Williams's claim that ETE is equitably estopped from terminating the merger agreement because it represented that it knew of no fact at the time of execution of the merger agreement that would reasonably be expected to prevent the second step of the transaction from qualifying under Section 721(a) of the Internal Revenue Code. On this point, the Supreme Court agreed with the Court of Chancery that ETE did not breach this representation because 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.

Dissent

Chief Justice Strine dissented from the majority opinion, first stressing the importance of viewing the case through the correct "lens"—i.e., applying the correct burden of proof. Both Chief Justice Strine's dissent and the majority opinion agreed that the Court of Chancery misapplied the burden of proof and that ETE should have been required to show causation. The "commercially reasonable efforts" term, the dissent pointed out, obligated ETE to take affirmative steps to ensure satisfaction of the 721 opinion condition, and because it did not, ETE must then prove that the 721 opinion condition would not have been satisfied had it acted appropriately.

The dissent disagreed, however, with the majority's conclusion that the result in the case would have necessarily been the same even if the Court of Chancery correctly applied the burden of proof, as numerous facts existed to show that ETE's actions may have led to the failure to obtain the 721 opinion. For example, among other things, the Chief Justice cited (i) facts suggesting that ETE discouraged its tax counsel from collaborating with its deal counsel (who encouraged a collaborative fix), its second tax lawyers and Williams's deal counsel to reach a resolution, (ii) evidence showing that ETE and its tax counsel kept Williams and its counsel uninformed about the inability to render the 721 opinion for a "commercially unreasonable and thus highly suspect" period of time, (iii) facts suggesting that ETE rushed to amend its proxy to disclose tax counsel's decision not to render the 721 opinion, and (iv) evidence suggesting that ETE and its counsel did not seriously consider possible solutions suggested by Williams's counsel, at least one of which experts and other ETE counsel believed may have been viable. As such, the dissent concluded that the case should be remanded with a requirement for a new trial at which ETE would be required to prove that its breach did not materially contribute to the failure of tax counsel to deliver the 721 opinion.

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