Energy Transfer May Terminate Merger Agreement Based on Lack of Tax Opinion

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In a litigation involving one of the biggest M&A deals in 2015, the Delaware Court of Chancery ruled that it will not compel Energy Transfer Equity, L.P. to complete its proposed acquisition of The Williams Companies, Inc. It is a condition precedent to Energy Transfer's obligation to complete the merger that Energy Transfer's tax counsel deliver an opinion with respect to certain tax aspects of the complex transaction.

The Court found that, when the merger was initially agreed, Energy Transfer and its counsel believed that such opinion could be rendered. But, after a review of the deal structure precipitated by the severe downturn in energy markets, Energy Transfer's tax counsel recognized it had never considered the significance of movements in equity value between signing and closing and concluded that it could no longer render the required opinion. The Court found that Energy Transfer's yearning for a soft exit from the transaction because of the declining market conditions was not sufficient to establish that it had breached its obligation to use commercially reasonable efforts to secure the tax opinion. Consequently, Energy Transfer may rely on the failure of the tax opinion condition and terminate the merger agreement at the outside date.

In September 2015, Williams and Energy Transfer entered into a merger agreement pursuant to which Energy Transfer would acquire Williams in a complicated transaction that involved a mixture of cash and equity. By Spring 2016, Energy Transfer was examining potential responses to the energy market downturn and first realized that a cash-for-stock exchange element of the proposed merger transaction might not receive the expected tax free treatment and that its tax counsel would not be able to deliver the related "Section 721" opinion. That opinion related to the way in which Energy Transfer was to fund $6 billion of cash merger consideration[1]. The tax issue is whether the cash payment should be treated as the non-taxable purchase price of equity in an affiliate of Energy Transfer that was worth $6 billion at signing but much less now because of the drop in oil prices or, instead, as the taxable proceeds of a disguised sale of Williams' assets. Delivery of such opinion was a condition to closing of the merger. Williams filed suit in Delaware seeking a declaratory judgment preventing Energy Transfer from terminating the merger agreement due to the failure of its tax counsel to deliver the Section 721 opinion. In response, Energy Transfer counterclaimed seeking a declaratory judgment that, if its tax counsel is unable to deliver the Section 721 opinion prior to the outside date under the merger agreement, Energy Transfer would be entitled to terminate the merger agreement without penalty due to the failure of a closing condition.

[1] The merger agreement contemplates that Energy Transfer would form Energy Transfer Corp LP ("ETC"), the entity into which Williams would merge. Upon completion of the merger, ETC would transfer the former Williams assets and 19% of ETC's common stock to Energy Transfer in return for partnership units of Energy Transfer that were supposed to be equivalent in value to the ETC stock, together with $6 billion in cash. The cash would then be distributed to the former Williams stockholders. It was the parties' intentions that the contribution of Williams assets in exchange for Energy Transfer equity be treated as tax free under Section 721(a) of the Internal Revenue Code.

The Court focused on whether, in determining its inability to issue the 721 opinion, Energy Transfer's tax counsel acted in good faith or, as Williams contended, "at the direction" of Energy Transfer and "not based on its independent conclusion." The Court found that, based on the evidence in the record, Energy Transfer's tax counsel had not acted in bad faith. Absent any record of "any explicit or implicit direction" by Energy Transfer to the tax counsel not to issue the Section 721 opinion, the Court held that the tax counsel acted in good faith when it concluded that it was unable to issue the 721 opinion.

The Court then turned to whether Energy Transfer was in material breach of its obligation to use "commercially reasonable efforts" to obtain the Section 721 opinion. The Court noted that "commercially reasonable efforts" should be "an objective standard," that is, "to do those things objectively reasonable to produce the desired Section 721 opinion, in the context of the agreement reached by the parties." Finding that Williams failed to demonstrate any commercially reasonable efforts that Energy Transfer could have taken that would have caused its tax counsel to issue the Section 721 opinion, the Court determined there was no material breach on the part of Energy Transfer, despite the fact that Energy Transfer had good reason to avoid the merger.

With no finding of a material breach by Energy Transfer, and a determination that its tax counsel had acted in good faith, the Court ultimately determined that the conditions precedent in the merger agreement must be enforced and the parties could not be required to consummate the proposed transaction without the comfort of the tax opinion. The Court therefore declared that Energy Transfer could terminate the merger agreement if the Section 721 opinion remained unavailable at the outside date under the merger agreement.

The Court's ruling highlights the importance of fully considering the implications of conditions precedent, particularly those which can be affected by changing market conditions or which are in the control of third parties. In a similar context involving a party with buyer's remorse, *Hexion Specialty Chemicals, Inc. v. Huntsman Corp.,* the Delaware Chancery Court noted how the target, Huntsman, specifically bargained for the right to have its own CFO deliver a solvency letter which was a condition to the funding obligations of the buyer's banks. In the Energy Transfer case, there may have been other firms willing to issue the required opinion (for example Williams' counsel), but the delivery of such an opinion by alternative means would not have satisfied the specific condition. The opinion also, unsurprisingly, confirms that a Delaware Court will not require a party to force its counsel to render an opinion that the law firm, in good faith, is unwilling to give. Such actions would exceed any objective standard of "commercially reasonable efforts" imposed on a party to a merger agreement.

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