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Delaware Supreme Court Affirms Energy Transfer's Termination of Merger Agreement for Lack of Tax Opinion

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Resolving a dispute surrounding one of the largest M&A deals of 2015, the Delaware Supreme Court affirmed the Delaware Chancery Court's decision allowing Energy Transfer Equity, L.P. to terminate its proposed acquisition of The Williams Companies, Inc. due to the inability of Energy Transfer's tax counsel to deliver a necessary tax opinion.

The Supreme Court focused its decision on Energy Transfer's obligation to use its "reasonable best efforts" to complete the deal and "commercially reasonable efforts" to obtain the required tax opinion. These covenants, it found, were affirmative obligations of Energy Transfer to take all reasonable actions to complete the merger. This contrasted with the Chancery Court's decision that Energy Transfer satisfied its obligations by merely not actively seeking to thwart the transaction when its tax counsel determined that it could not deliver the necessary opinion. The Supreme Court, nevertheless, found that any alleged breach by Energy Transfer could not have materially contributed to the failure to obtain the tax opinion and, therefore, affirmed the Chancery Court's decision.

Background

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, which made the transaction financially challenging. At this time, Energy Transfer realized that an assets-for-equity exchange element of the 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. Delivery of such opinion was a condition to closing of the merger and Energy Transfer indicated that it would not proceed with the merger. Williams filed suit in Delaware seeking a declaratory judgment that Energy Transfer had committed material breaches of the merger agreement and to enjoin 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 was 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.

In its June 2016 decision, the Chancery Court found that Energy Transfer's tax counsel had not acted in bad faith by failing to issue the Section 721 opinion and that Energy Transfer was not in material breach of its obligation to use "commercially reasonable efforts" to obtain such opinion. As a result, the Chancery Court determined that the closing condition to the merger agreement must be enforced and Energy Transfer was permitted to terminate the merger agreement. Williams appealed the Chancery Court's decision to the Delaware Supreme Court.

The Supreme Court's Decision

The Supreme Court found that the Chancery Court erred by adopting an "unduly narrow" view of the obligations imposed on Energy Transfer under the merger agreement. Instead of focusing on the absence of any evidence that Energy Transfer caused its tax counsel to withhold the Section 721 opinion, the Supreme Court held that the Chancery Court should have analyzed whether Energy Transfer had taken all reasonable steps to obtain the Section 721 opinion. If such a proper analysis had shown Energy Transfer to have breached its covenants under the merger agreement, Energy Transfer should then have had the burden of showing that such breach did not materially contribute to the failure of the transaction. The Supreme Court's decision to affirm relied on the lower court's findings of fact that the record was "barren" of any indication that Energy Transfer's action or inaction contributed materially to its tax counsel's inability to render the Section 721 opinion.

Chief Justice Leo E. Strine dissented from the Supreme Court's majority opinion. Strine would have remanded the case to the Chancery Court for a fresh analysis of the facts to determine whether or not, in fact, Energy Transfer's actions contributed to the failure of the tax opinion condition.

Conclusion

The Supreme Court's decision clarifies the approach Delaware courts will take when reviewing parties' obligations to use "reasonable best efforts" or "commercially reasonable efforts." These constitute affirmative obligations on the parties to take all reasonable steps to solve problems and consummate the transaction, and merely standing aside to allow a condition to fail may result in a breach of such obligations. However, once a breach of such a covenant is established, the burden is on the breaching party to show that the breach did not materially contribute to the failure of the transaction, and the plaintiff has no obligation to show what steps the breaching party could have taken to consummate the transaction.

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