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SIDLEY UPDATE

For Want of a Tax Opinion Nail, a Megadeal War Is Lost

After an expedited trial in the Delaware Court of Chancery, the Court denied The Williams Companies, Inc.'s (Williams) request for an order requiring Energy Transfer Equity, L.P. (ETE) to close a deal to acquire Williams valued at more than $30 billion. The case turned on whether a contractual condition to closing—that the law firm Latham & Watkins LLP (ETE's tax counsel) (Latham) furnish an opinion that the contribution of Williams' assets to ETE should be treated as a tax-free exchange—had validly failed to occur. In a 58-page opinion, the Court concluded that "Latham, as of the time of trial, could not in good faith opine that tax authorities should treat the. . .exchange . . .as tax free under Section 721(a); and [that] because Williams has failed to demonstrate that [ETE] has materially breached its contractual obligation to undertake commercially reasonable efforts to receive such an opinion from Latham, . . [ETE] is contractually entitled to terminate the Merger Agreement, assuming Latham's opinion does not change before the end of the merger period . . ."[1]

The Facts

In September 2015, ETE and Williams entered into a two-step merger agreement under which Williams would merge into an ETE affiliate, Energy Transfer Corp LP (ETC), a specially created Delaware limited partnership, and the shareholders of Williams would receive limited partner interests in ETC and $6.05 billion in cash. ETC would fund the cash portion of the acquisition consideration by way of the issuance of some of its limited partner interests to ETE, and upon completion of the first-step merger, ETC would transfer all the former Williams assets to ETE, in exchange for ETE partnership units. The former Williams stockholders would end up owning (in addition to the $6.05 billion) approximately 81% of the outstanding ETC limited partner interests.

A critical economic premise of the transaction was that the acquisition of the Williams assets by ETE would be tax free. Therefore, the merger agreement required, as a material condition to closing, that Latham issue an opinion under Section 721(a) of the Internal Revenue Code (the 721 Opinion) that the Williams-assets-for-ETE-partnership-unit component of the transaction "should" (meaning that it quite likely would) be treated by the tax authorities as a tax-free exchange. As the Court described it, at the time the merger agreement was signed, neither Latham nor the other counsel working on the transaction viewed this condition as problematic, because the cash component of the transaction was, at that point, consideration for ETC limited partner units of equivalent value. However, that view soon radically changed.

[1] *The Williams Companies, Inc. v. Energy Transfer Equity, L.P.*, C.A. No. 12168—VCG (Del. Ch. Jun. 24, 2016); Mem. Op. at 4.

Shortly after the merger agreement was signed, the energy market—and the value of energy transportation assets—precipitously declined. So too did the value of the ETE's publicly traded partnership units, which dropped to between one-third and one-half of their value at signing. Since ETE would have to borrow against its devalued assets to pay the $6.05 billion cash portion of the consideration, the transaction became financially unpalatable to ETE. ETE earnestly desired to exit the proposed merger, as it was in ETE's interest to avoid that transaction if possible. In early 2016, while evaluating the tax implications of the transaction for unrelated purposes, ETE's Head of Tax became concerned that the diminution of the value of the partnership units to be issued to ETC (and, since ETC would own only ETE limited partner interests, the diminution of the ETC limited partner interests issued in exchange for $6.05 billion) created the risk that a portion of cash paid by ETE to ETC could be treated as consideration for the Williams assets and the transaction might be treated in part as a taxable exchange.[2] ETE communicated that concern to Latham, whose tax lawyers concluded, after considerable study and analysis, that it could no longer opine that the tax authorities "should" treat the contribution of Williams assets for ETE partnership units as a tax-free transaction. ETE and Latham advised Williams of Latham's conclusion, and on that basis ETE took the position, despite Williams' emphatic disagreement and objection, that it was contractually free to terminate the transaction. That impasse ultimately led to Williams bringing its Chancery action to compel ETE to complete the merger.

The Court's Opinion

In its lawsuit, Williams sought a declaratory judgment that ETE was estopped from exercising its right to terminate, on the ground that ETE had materially breached its obligation under the merger agreement to use "commercially reasonable efforts" to obtain the 721 Opinion from Latham. Williams also sought an injunction precluding ETE from terminating the merger transaction on that basis. Williams' claim was predicated upon its contention that Latham had arrived at its 721 Opinion determination in bad faith. The parties' colliding positions generated the two issues that the Court addressed in its opinion: (1) whether Latham had reached its conclusion in good faith, and (2) if so, whether ETE had materially breached its contractual requirement to make commercially reasonable efforts to obtain the 721 Opinion.

The first issue, as framed by the Court, was whether Latham had determined in "subjective good faith" that it could not issue the 721 Opinion. The Court found, as fact and based on the evidentiary record, that Latham had reached its conclusion, based upon its uninfluenced independent judgment, in subjective good faith. The factual bases for so concluding (among others) were that Latham was a law firm of "national and international repute," that its interests were larger than those of this particular representation, that its inability to issue the 721 Opinion was a "substantial embarrassment" to Latham despite its initial view that it could do so, and that upholding its reputation in the legal community outweighed any potential benefit of unethically deferring to the interests of this single client. As the Court noted, "while this deal is, certainly, a lunker, Latham has even bigger fish to fry."

Turning to the second issue, Vice Chancellor Glasscock noted that "commercially reasonable efforts" was not defined in the merger agreement, and that "the term is not addressed with particular coherence in our case law." Citing earlier Supreme Court precedent,[3] the Court found that "commercially reasonable efforts" required the

[2] *See* footnote 1, *supra* at 17.

[3] *Hexion Specialty Chemicals, Inc. v. Huntsman Corp.*, 965 A.2d 715 (Del. 2008).

purchaser (ETE) to submit itself to an "objective standard—that is, [ETE] bound itself to do those things objectively reasonable to produce the desired 721 Opinion, in the context of the agreement between the parties." In confronting this issue, the Court found as fact that ETE was motivated to exit the transaction if it could, and "approached this matter with a skeptical eye, in light of that motivation." But even so, "[j]ust as motive alone cannot establish criminal guilt. . . motive to avoid a deal does not demonstrate lack of a contractual right to do so." Having reviewed the evidence, the Court concluded that Williams could "point to no commercially reasonable efforts that [ETE] could have taken to consummate the [merger]; specifically. . . actions available to [ETE] that would have caused Latham, acting in good faith, to issue the 721 Opinion. The record demonstrates no such actions available to [ETE]." Moreover, "[t]here is simply nothing that indicates. . . that [ETE] has manipulated the knowledge or ability of Latham to render the 721 Opinion, or failed to fully inform Latham, or do anything else, whether or not commercially reasonable, to obstruct Latham's issuance of the condition-precedent 721 Opinion, or that had a material effect on Latham's decision."

For these reasons, the Court granted judgment in favor of ETE which Williams has appealed to the Delaware Supreme Court.

If you have any questions regarding this Sidley Update, please contact the Sidley lawyer with whom you usually work, or

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