Importance of Closing Conditions in Mergers

Williams Companies, Inc. v Energy Transfer Equity, L.P. – Court of Chancery of the State of Delaware

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On June 24, 2016 the Delaware Court of Chancery ruled on a dispute with implications for lawyers and companies negotiating closing conditions in a merger agreement. The dispute in *Williams Companies, Inc. v Energy Transfer Equity, L.P.* centered on a legal opinion to be delivered by the purchaser's tax counsel prior to closing. The purchasers were able to terminate the merger agreement when their counsel refused to deliver the opinion. Practitioners negotiating merger agreements will want to pay special attention to the lessons of *Williams* before agreeing to any closing conditions or committing to use "commercially reasonable" efforts to meet pre-closing obligations.

Background

The Williams Companies, Inc. ("Williams"), a Delaware corporation, and Energy Transfer Equity, L.P. (the "Partnership"), a Delaware limited partnership, are major operators in the energy infrastructure sector. The companies entered into a merger agreement in September of 2015. The merger was an unusual structure, designed to accommodate Williams' desire for its stockholders to continue to hold publicly traded common stock. Due to the complex structure, there were potential negative tax ramifications to the merger that the parties negotiated comprehensively.

Under the terms of the merger agreement, the Partnership created a subsidiary into which Williams would merge. The subsidiary would then transfer the former Williams assets and 19% of the subsidiary's common stock to the Partnership, in return for partnership units and $6 billion in cash.

Before the transaction closed, the energy industry, and the market for energy infrastructure, collapsed. In order to purchase Williams, the Partnership planned to borrow the $6 billion in cash using its assets, now greatly devalued, as collateral. The Partnership's management became concerned about its potential debt level as result of the proposed merger and the merger was no longer financially appealing to the Partnership. As a condition precedent to the merger, the Partnership's tax counsel was to issue an opinion that a specific feature of the complex structure should be treated by the tax authorities as a tax-free exchange under Section 721(a) of the Internal Revenue Code (the "721 Opinion"). The Partnership's tax counsel refused to issue the 721 Opinion and the Partnership terminated the merger agreement. Williams brought suit before the Court of Chancery in the State of Delaware, claiming that the Partnership's tax counsel acted in bad faith and the Partnership materially breached its contractual obligation to use "commercially reasonable efforts" to secure the 721 Opinion.

Did Counsel Act in Bad Faith?

Williams' argument that Partnership's counsel acted in bad faith relied on three main points. First, the Partnership wanted an out from the merger. Second, and disputed, was that no reasonable tax attorney could reach the conclusion the Partnership's tax counsel reached when they refused to issue the 721 Opinion. Third, Williams deduced from points one and two that the Partnership's tax counsel must, therefore, be acting at the direction of, or on behalf of, the Partnership, and not based on its independent conclusion, in failing to issue the 721 Opinion. The court noted that the record did not contain any explicit or implicit direction by the Partnership to the Partnership's tax counsel to reach a particular outcome. The court rejected Williams' conclusions. It believed there was evidence that the Partnership's tax counsel reached its conclusion based upon its independent judgment despite counsel's obvious knowledge that its client would like to exit the deal.

The court declined to determine whether the Partnership's tax counsel's interpretation of the Section 721(a) was correct. It determined that it was not appropriate for the court to substitute its judgment on the Section 721(a) issue for that of the Partnership's counsel. Instead the court's role in these cases is to determine whether counsel's refusal to issue the opinion was in good faith, in other words, was counsel's refusal to issue the opinion based on counsel's independent expertise as applied to the facts of the transaction.

Commercially Reasonable Efforts

Having found that the Partnership's tax counsel refused to issue the 721 Opinion in good faith, the court turned to the issue of whether the Partnership was in material breach of its covenant to use commercially reasonable efforts to secure the 721 Opinion. The court noted that the term "commercially reasonable efforts" has not been well defined in the case law but stated "the Partnership necessarily submitted itself to an objective standard—that is, it bound itself to do those things objectively reasonable to produce the desired 721 Opinion." The court had no doubt that the Partnership experienced "bitter buyer's remorse" but "there is simply nothing that indicates to [the court] that the Partnership has 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, whether or not commercially reasonable, 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 Court's Ruling

The court held for the Partnership, stating "It is clear to me that the [merger], so ardently desired by the Partnership at the time the deal was inked, is now manifestly unattractive to the Partnership. . . It is that motivation on which Williams primarily relies to demonstrate lack of "commercially reasonable efforts" on the part of the Partnership. I approached this matter with a skeptical eye, in light of that motivation . . . however, motive to avoid a deal does not demonstrate lack of a contractual right to do so. . . Because I conclude that [the Partnership's tax counsel], as of the time of trial, could not in good faith opine that tax authorities should treat the specific exchange in question as tax free under Section 721(a); and because Williams has failed to demonstrate that the Partnership has materially breached its contractual obligation to undertake commercially reasonable efforts to receive such an opinion from [the Partnership's tax counsel], I find that the Partnership is contractually entitled to terminate the merger agreement. . ."

The court went on to say, "The merger agreement is subject to Delaware law. Delaware is strongly contractarian, and the presence of a provision in favor of specific performance in case of breach, as the parties contracted for here, must be respected. Conditions precedent to the transaction must be enforced as well, and granting Williams' request to use the power of equity to consummate the proposed transaction would force the Partnership to accept a risk – potential imposition of substantial tax liability – without the comfort of a tax opinion from [its legal counsel]."

Lessons

As the court noted in *Williams*, the meaning of "commercially reasonable efforts" was not well defined in prior case law. *Williams* gives practitioners some guidance. A "commercially reasonable effort" is an objective standard. The courts will ask whether the parties have done those things objectively reasonable to produce the closing deliverable or meeting their commitments.

Williams makes it clear that in Delaware the courts will give deference to contractual provisions as they are written. Closing conditions requiring the opinion of third-parties or legal counsel will be enforced, even if there is an appearance of impropriety or ulterior motives, unless bad-faith on the part of the third-party or legal counsel can clearly be demonstrated. Practitioners who negotiate closing conditions should carefully consider what opinions are required and which parties will be able to waive the closing condition if those opinions are delayed or unavailable.

It is important to note that *Williams* has been appealed and practitioners should continue to follow developments in the case law.

For more information, please contact a member of our M&A Team.