Securities Regulation Daily Wrap Up, MERGERS AND ACQUISITIONS—Del. Ch.: Tax condition lets oil company out of unfavorable merger, (Jun. 27, 2016)

Securities Regulation Daily Wrap Up

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By Anne Sherry, J.D.

The inability to procure a legal opinion allowed Energy Transfer Equity, L.P. (ETE) to back out of an unfavorable merger with The Williams Companies, Inc. The energy market tanked after the parties agreed to the merger, rendering it a bad deal for ETE, which would have had to borrow $6 billion against its devalued assets to pay the fixed cash price. The Delaware Chancery Court took a skeptical view as a result, but observed that "motive to avoid a deal does not demonstrate lack of a contractual right to do so" (*The Williams Companies, Inc. v. Energy Transfer Equity, L.P.*, June 24, 2016, Glasscock, S.).

Merger mechanics. Both Williams' stock and ETE's common units trade on the NYSE. The deal was structured so that Williams shareholders would retain publicly traded stock post-closing and receive a substantial cash payment. ETE created a new limited partnership, taxable as a corporation, into which Williams would merge. The new entity would then transfer 19 percent of its own stock, in addition to the former Williams assets, to ETE in exchange for partnership units and $6 billion in cash. The cash would be distributed to the former Williams stockholders.

ETE pursued the deal "assiduously," and the parties negotiated heavily to come to an agreement that they executed on September 28, 2015. The merger's potential tax ramifications were a particular concern. Although the deal does not give ETE a financing or solvency out, a condition precedent to consummation of the merger is that ETE's tax attorneys, Latham & Watkins, issue an opinion that a specific transaction "should" be treated as a tax-free exchange under the Internal Revenue Code. Latham has been unable to issue that opinion, and that is unlikely to change before June 28, the outside date for consummating the merger.

Contract trumps motive. Williams maintained that ETE was estopped from leveraging the condition precedent because it breached the merger agreement by failing to use "commercially reasonable efforts" to secure the legal opinion. This is an equitable argument, and the court observed that Delaware law, which governed the agreement, is "strongly contractarian." Using equity to consummate the merger would force ETE to accept the potential tax risk without the comfort of a tax opinion from Latham.

Latham's good faith. The court examined the various interests that colored its interpretation of the facts. The sophisticated parties negotiated a condition precedent that required a subjective opinion and assigned that determination to ETE's tax lawyer rather than a neutral third party, the court noted. It was not appropriate to substitute the court's judgment on the tax issue for that of Latham; the court's role was to determine whether the refusal to issue the opinion is in good faith. On the other hand, the court had to look at Latham's decision—which favored its client—"with a somewhat jaundiced eye." Latham was originally prepared to issue the opinion, but reconsidered after the market stacked the deal against ETE. However, Latham is a large, international firm whose interests are larger than those of this particular representation. Clients generally want their deals to go through; Latham's deal-breaking conclusion was counter to the firm's reputational interest going forward.

The court found that Latham made its determination in good faith and that a condition precedent to the consummation of the merger has not been met. Under the relevant Internal Revenue Code provision, a contribution of property for an interest in a partnership is not a taxable event. But the merger included another exchange, of $6 billion in cash for shares of the new LP. The drop in value of ETE units meant that the cash transaction represented a payment of $6 billion for between $2 and $3 billion worth of stock. The tax authorities

could consider the overpayment to be part of a hidden sale of assets, which would trigger tax liability. At the time the agreement was executed, the cash transaction involved assets of equivalent value, and Latham was able to give an opinion that the transaction should be considered a tax-free event. But the drop in the shares' value, relative to the fixed cash payment, changed that. ETE hired Morgan Lewis attorneys and a professor to examine the transaction; both also concluded that it was likely to trigger tax liability.

ETE did not breach. The merger agreement required ETE to use "commercially reasonable efforts" to obtain the legal opinion, but it did not define the phrase. This was an objective standard, the court determined. But Williams could point to no commercially reasonable efforts that ETE could have taken to cause Latham to issue the legal opinion in good faith. Whatever ETE's motivations, there was no material breach on the facts before the court.

The case is No. 12168-VCG.

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Companies: The Williams Companies, Inc.; Energy Transfer Equity, LP; LE GP, LLC; Energy Transfer Corp. LP

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