ETE-Williams Heightens Focus on Deal Certainty—Advance Planning to Lower Risk of Non-Satisfaction of Closing Conditions

In response to the Delaware Court of Chancery's decision in *Energy Transfer Equity v. Williams* (June 24, 2016), merger parties likely will intensify their focus on deal certainty. Although a number of unusual characteristics of the ETE-Williams transaction led to both the issue in the case and the judicial result, *ETE* highlights that merger parties should understand and seek to redress the risks of (and detriment from) non-satisfaction of closing conditions. Depending on the facts and circumstances, it may advantage a company (particularly a target company—and even more so if the company is foregoing an alternative transaction) to take an aggressive approach in narrowing closing conditions when negotiating a merger agreement.

Background

The Williams Companies, Inc. abandoned a contemplated roll-up transaction so that it could, instead, be acquired by Energy Transfer Equity, L.P. The transaction, valued at signing at $38 billion, involved a novel structure, crafted to accommodate Williams' desire for its stockholders to continue to be holders of publicly traded stock (as opposed to ETE partnership units) and to receive a substantial ($6 billion) cash payment, in exchange for its assets being acquired by ETE. The transaction was subject to customary closing conditions—including a condition to both ETE's and Williams' obligations to close that ETE's counsel deliver at closing a legal opinion that one of the steps in the transaction "should" be treated by the tax authorities as a tax-free exchange. The merger agreement required that the parties use "commercially reasonable efforts" to satisfy all of the conditions.

After the merger agreement was signed in December 2015, the decline in energy industry properties accelerated precipitously and, according to the court, ETE developed "bitter buyer's remorse" and "strongly wanted to exit the transaction." Thereafter, in a development rarely (if ever) seen in connection with a tax opinion closing condition (absent a change in law between signing and closing), ETE's tax counsel (after considering an issue raised by ETE's internal tax lawyer) "backtracked" on its earlier tax advice and determined that it could not deliver the tax opinion. Williams contended that the tax counsel had acted in bad faith—*i.e.*, that the decision not to deliver the opinion was not based on the firm's best legal judgment but on its wanting to accommodate its client by providing a pretext for the client to terminate the agreement. Williams argued, further, that ETE had not used reasonable efforts to obtain the opinion, based on ETE's internal Head of Tax having brought the problematic tax issue to the attention of ETE's tax counsel and on ETE's having rejected proposed revisions to the deal structure designed by Williams' counsel to resolve the issue.

After a two-day expedited trial, which came just days before the merger agreement's "drop dead" date, the court held that ETE was not required to close. Vice Chancellor Sam Glasscock III wrote that the court had evaluated the case "with a jaundiced eye," given ETE's strong desire to exit the transaction for reasons unrelated to the tax opinion. The court emphasized, however, that there was no evidence that ETE had influenced its counsel not to deliver the opinion. "Just as motive alone cannot establish criminal guilt,…motive to avoid a deal does not demonstrate lack of a contractual right to do so," the court wrote.

ETE terminated the transaction on June 29; and Williams has appealed the decision to the Delaware Supreme Court on a non-expedited basis.

Key Points

- **The decision highlights the potential for even customary closing conditions to lead to deal termination.** A merger party should assess the degree of risk associated with closing the transaction; evaluate whether there are any unusual risks; and consider whether—and, if so, how—it will seek greater certainty of closing and/or remedies in the event of a failure to close. Attention should be paid to *each* condition, including conditions that have been considered to be customary and have not typically been the subject of dispute. In response to *ETE*, merger parties may now, depending on the circumstances, consider taking more aggressive positions than in the past to seek to eliminate or modify, or to provide remedies for non-satisfaction of, closing conditions—to reduce the risk of non-satisfaction of conditions later being used by the other party as a pretext to exit the transaction due to a change of heart.

- **Reconsideration of customary closing conditions is most important where there are "red flags" as to closing certainty.** A careful evaluation, as described above, is particularly important if a condition involves receipt of an opinion from the counterparty's own advisor, there is a novel deal structure, or the nature of the transaction or market or other conditions may give rise to issues that could result in failure of a condition. A part-stock part-cash deal, for example (particularly if, as in *ETE*, the cash component is large and fixed), may raise issues relating to tax opinions that should lead the parties to consider whether additional precautions (including contractual) are advisable. By contrast, all-cash deals should not raise tax issues but could have more potential to give rise to buyer's remorse in the event of significant market dislocations.

- **The *ETE* situation involved a number of unusual characteristics, which led to the tax issue and the judicial result.** A highly unusual deal structure, an unusually volatile market, and a large fixed cash component of the merger consideration all combined to permit a colorable concern about the contemplated tax treatment for the transaction. Further, and both critically and unusually, only an opinion delivered by ETE's one named tax counsel could satisfy the tax opinion condition; there was no alternative presented to remedy the failure of receiving the opinion; and there was no evidence (*i.e.*, no emails, other contemporaneous communications, or other evidence) that ETE had influenced its counsel not to deliver the opinion.

- **The court tends to interpret merger provisions *as drafted* by sophisticated parties, without reading into the agreement protections that were not specifically negotiated and agreed.** We note that the court ruled that non-delivery by the named counsel of the tax opinion gave ETE the right not to close *notwithstanding that*:

    - ETE wanted to terminate for other reasons and the named counsel was ETE's own counsel;

  - The issue only arose based on a fortuitous "epiphany" of ETE's internal Head of Tax that his view, prior to signing of the merger agreement, that the transaction should be tax-free was based on his mistaken understanding about the deal terms. Specifically, he testified that he thought that cash would be contributed, in a critical step of the transaction, for a *floating* number of shares rather than, as was actually the case, a fixed number—"[d]espite the fact," according to the court, "that he had reviewed drafts of transaction documents and other deal-related materials that said otherwise, and … no one else shared his view….";
  - The issue that arose (based on a decline in the market value of the target's assets) presumably could have been anticipated at the time ETE's and Williams' counsel both preliminarily advised that the transaction should be tax-free; and
  - There was no consideration by the court as to whether the potential tax liability, or the net tax liability after taking into account a step-up in basis of the contributed assets, would be material to the transaction.

- **If satisfaction of a condition is based on delivery of an opinion by one named counsel, the court will look to the "subjective belief" of that counsel and will not substitute its own judgment.** The court emphasized that the tax opinion condition that was negotiated required a specific standard of certainty (a so-called "should" opinion—*i.e.*, that the transaction "should be" regarded by the tax authorities as a tax-free exchange, which standard was characterized by the court as "meaning that it is quite likely" and that there is "substantial certainty" as to the tax result). Further, the court emphasized that the provision, as negotiated, required that the opinion be delivered by one specific law firm. The court noted that the parties could have required, but did not require, the lesser standard of "more likely than not"; the higher standard of "will"; or an objective standard as to what constitutes compliance, to be provided by a court or an arbitrator. They could have provided, but did *not* provide, for alternative counsel to provide the opinion if the named counsel could not. "Therefore," the court concluded, "it is [ETE counsel]'s subjective good-faith determination that is the condition precedent … [and the court's] role is to determine whether [the firm's] refusal to issue [the] opinion is in good faith, that is, based on [its] independent expertise as applied to the facts of the transaction." Good faith, in this respect, appears to mean simply that the counsel *actually had* the subjective belief that the tax opinion could not be delivered and had some foundation (whether ultimately right or wrong) for the belief.

- **The court determined that ETE's tax counsel *had* acted in good faith (*i.e.*, subjectively believed that the tax opinion could not be delivered), based on the court's view that:**
  - ETE's tax counsel "took its responsibility seriously," "devoted considerable effort" (including over 1,000 hours of attorney time), and "marshaled its tax attorneys and extensively analyzed the regulations and case law";
  - Its integrity and reputation were likely more important motivating forces for ETE's counsel than a desire to accommodate a single client's desire to exit a transaction;
  - It was against the "reputational interest" of ETE's counsel to have "backtracked" after having "preliminarily advised that the deal would qualify for a certain tax treatment";
  - As the transaction structure was novel, there was "little persuasive authority in the case law regarding [the] anticipated perception by tax authorities of this complicated transfer";

  - There was a wide "range of opinion" among other law firms and experts engaged by the parties as to whether a "should" opinion could be issued (with a firm contacted by ETE's Head of Tax for a "fresh look" at the opinion issue agreeing with ETE tax counsel's conclusion but for different reasons than ETE's tax counsel had; and with a firm Williams consulted for a "fresh look" at the tax issue initially responding that it would be "difficult to get to should," and ultimately concluding that, if asked, it could issue only a "weak-should" opinion)—all of which, according to the court, "indicate[d] the closeness of the issue and the unusual nature of the transaction"; and, *critically,*

  - The record was "bereft of any explicit or implicit direction by [ETE] to [its tax counsel] to reach a particular outcome." The court distinguished prior cases in which the court had found breaches of efforts clauses, noting that, in those cases, there had been evidence of affirmative actions taken by a party to frustrate satisfaction of a condition. Indeed, the court stated that if the "record here reflected affirmative acts by [ETE] to coerce or mislead [its counsel], by which actions it prevented issuance of the [tax opinion], … the outcome here would likely be different."

- **The court tends not to use the "efforts" clause in a merger agreement to read in protections for a party that were not specifically negotiated and agreed.** In connection with finding that ETE did not breach its contractual obligation to use commercially reasonable efforts to obtain the tax opinion, the court acknowledged that ETE had ***not***:

  - Directed its tax counsel to engage earlier or more fully with Williams' counsel;

  - Negotiated the tax-related issues directly with Williams;

  - Coordinated a response among the various players;

  - Kept non-public the fact that its counsel had declined to issue the tax opinion; or

  - Generally acted like an enthusiastic partner pursuing consummation of the transaction.

  However, the court stated, there was no evidence that these actions or inaction by ETE "caused, or had a material effect upon" ETE counsel's decision that it could not issue the tax opinion.

  The court did not reach the issue of whether ETE would have been obligated to restructure the transaction to resolve its tax concerns—because ETE's counsel concluded that the restructuring proposed by William's counsel would not have resolved its concerns. We caution that, where the issues are less uncertain than were the tax issues in *ETE*, and to the extent that a restructuring proposal involves changes that are not significant, a party *may* have an obligation to restructure to facilitate satisfaction of a condition, depending on the level of efforts contractually required.

- **Ability to exit a transaction based on non-satisfaction of conditions.** It is *not usual* that a buyer or seller with post-signing "remorse" can utilize non-satisfaction of conditions as a pretext for exiting a transaction. For example, the courts have tended to interpret "material adverse change" conditions, and other conditions requiring judgment with respect to *subjective* events, to provide buyers with a right to terminate a transaction only under unusual circumstances involving fundamental changes with long-term negative effect. By contrast, conditions that *objectively* have not been satisfied (such as a tax opinion—which, on an objective basis, will either have been delivered or not) are likely to permit exit from a transaction unless the non-satisfaction of the condition is on account of a breach of the contractually required efforts to satisfy it.

- **As noted, deal uncertainty increases when, as in *ETE*, there are:**
  - Volatile industry or market conditions (that could, for example, result in significant changes in value that could cause possible tax issues);
  - Novel aspects to the transaction structure (and, so, less clear authority with respect to tax and other issues, permitting colorable issues to arise); and/or
  - Conditions that may to some extent be within the control of the other party (such as its obtaining a tax opinion from its own counsel).
- **Importance of the record (including email and other communications).** A critical factor in *ETE* was that, although there was substantial evidence that ETE wanted to exit the transaction, there was no evidence that ETE tried to influence its counsel not to provide the tax opinion or that its tax counsel did not do substantive and detailed work in evaluating whether it was able to provide the opinion. *It cannot be emphasized enough that companies must keep in mind that emails and other contemporaneous communications can and will be an important part of the evidentiary record in the event litigation is brought relating to a transaction.*

Practice Points

- **Importance of due diligence to identify and evaluate the potential risks of a deal not being consummated.** A primary objective of due diligence should be to identify and evaluate the specific potential risks of the transaction not closing. The parties can then seek to avoid those risks through drafting or advance planning.
- **Specify steps that must be taken to meet the "efforts" obligation and/or specify pre-agreed "back-up" transaction structures**. Parties seeking to ensure certainty of closing may wish to specify steps that would be required to be taken as part of the contractually required standard of efforts by the parties to satisfy the conditions. In addition, parties may wish to specify alternative transaction structures that would be put into place in the event that issues arise with respect to certain conditions being satisfied. In connection with a tax opinion condition, the parties could specify that they would have to seek alternative counsel and/or consider restructuring the transaction, or would be obligated to effect a specified pre-agreed restructuring (that might, for example, reduce cash and substitute equity, possibly at a fixed ratio). In connection with a stockholder approval condition, the parties might wish to explore the feasibility of providing that, if approval of the acquiror's stockholders were required and could not be obtained, the parties would restructure the transaction (including by converting equity consideration to cash or non-voting securities) so that a stockholder vote would not be legally required.
- **Alternative formulations of tax opinion condition.**
  - In addition to a party's named tax counsel that will be engaged to provide the tax opinion to it, the parties may wish to name more than one firm and/or to provide that any nationally recognized law firm may be engaged to provide the opinion.

- Parties may wish to consider the feasibility of providing that their respective counsel will select a third firm to determine whether an opinion can be issued (and to issue it) if one party's counsel cannot deliver the opinion but the other party's counsel can; or, alternatively, they may consider agreeing that the condition will be satisfied if either party's counsel delivers the opinion to both parties.

- In lieu of a tax opinion condition, the parties could agree that the tax opinions be delivered *at signing*, with the condition being that there is no change in the tax laws that would materially adversely affect the validity of the opinion. (Note that this formulation does not protect the parties against changes in the factual context that could affect the tax outcome (*e.g.*, a decline in stock price) and would necessarily turn the closing condition opinion into a "hypothetical opinion" in that the opinion would express a view as to the tax results of a future transaction based on assumed facts the accuracy of which cannot be known with certainty until closing actually occurs.)

- As noted, the parties could agree in advance that they will restructure, convert the form of consideration, and/or take other steps necessary to address any substantive tax issue that may arise and prevent issuance of the opinion.

- Parties could agree in advance to waive a tax opinion condition if the potential tax liability (or *net* tax liability) is not "material" or does not exceed a specified amount or other standard.

- Where there is a higher potential than usual that issues may arise with respect to satisfaction of the tax opinion condition—and, particularly, where the condition is based on issuance of the opinion by a party's own counsel, or the standard of certainty for the opinion is high, the other party may seek to negotiate that a meaningful reverse termination fee will be payable in the event that the condition is not satisfied.

- If one party has the predominant underlying economic interest with respect to a tax opinion, consideration should be given to only that party being protected by the condition.

- **"True" hell-or-high water approach.** A possible response to *ETE* may be that target companies become more aggressive in seeking to achieve agreements that come closer to a true "hell-or-high-water" standard than in the past (particularly when the target has abandoned an alternative transaction). For example, a target company may seek:

  - to provide that the only bases on which the parties would not be obligated to close would be that legally required approvals are not obtained; or that the other party willfully breached its covenants set forth in the merger agreement, with a material adverse effect;

  - larger termination fees than in the past—more akin to the type of termination fees seen in regulatory-sensitive deals—and/or that the termination fee would be payable if the transaction is terminated for *any* reason other than failure of a short list of specified conditions (we note, though, that if termination is in favor of a competing bid, then, generally, a usual termination fee should be applicable); and/or

  - direct payment by a topping bidder of any breakup fee that the target may have to pay in connection with a transaction that the target will be terminating to accept the topping bid (so that, even if the topping transaction does not ultimately close for any reason, the termination fee payable by the target with respect to the abandoned transaction would have been paid by the topping bidder).

- **Precatory language underscoring the commitment to closing.** Parties seeking to maximize deal certainty could consider including precatory language in the merger agreement that expresses their strong commitment to closing and that requests that, in the event of a future dispute, a court interpret the merger agreement provisions to favor respecting the parties' intent that the transaction close. Such language would underscore the parties' intentions and should influence a court's interpretation of the agreement provisions.

- **Include litigators early in the negotiation and drafting process.** Litigators should be included early in the negotiation and drafting process to seek to ensure that the merger agreement reflects the parties' intentions with respect to deal certainty.

- **Drop dead date should provide time to resolve issues.** A target company may seek a right for longer-term extensions of a drop dead date than in the past (possibly, unless a larger than usual breakup fee is paid by the buyer). Merger parties should consider whether the drop dead date should be extendable in the event of unresolved litigation issues, or if other developments challenge deal certainty, or if the passage of time could (or would be likely to) eliminate the circumstances that have caused a failure of the condition (such as time for market dislocations to clear).

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