LOS ANGELES
Daily Journal
www.dailyjournal.com

THURSDAY, JULY 28, 2016

PERSPECTIVE

Delaware court dishes on conditions to closing a transaction

By Marc Boiron

Although the term 'commercially reasonable efforts' leaves much to be desired where parties are seeking certainty in a transaction, the court's interpretation of the term provides another marker to use when drafting a commercial agreement in which parties desire to define each other's required efforts in the transaction.

In *The Williams Companies, Inc. v. Energy Transfer Equity, L.P.*, the Delaware Court of Chancery considered whether a corporation was required to close a transaction even though its outside tax counsel would not issue a legal opinion, which was a condition to the closing of the transaction. The court determined that the corporation was entitled to terminate the merger agreement because it did not commit a material breach of the merger agreement. On June 29, the merger agreement was terminated. The decision has been appealed to the Delaware Supreme Court.

After lengthy negotiations, The Williams Companies, Inc. and Energy Transfer Equity, L.P. entered into a merger agreement, pursuant to which Williams would merge into Energy's affiliate, with the affiliate surviving the merger. In the merger, Williams' stockholders would receive consideration consisting of approximately 81 percent of the affiliate's outstanding shares, $6.05 billion in cash and certain contingent consideration rights. Energy would transfer the $6.05 billion to its affiliate in exchange for shares representing approximately 19 percent of the affiliate's outstanding stock. In addition, the affiliate would contribute Williams' assets in exchange for partnership units of Energy.

The closing of the merger was contingent upon Energy's outside tax counsel issuing an opinion to the effect that the transfer of Williams' assets to Energy should be a tax-free transfer under Section 721(a) of the Internal Revenue Code.

After entering into the merger agreement, conditions in the energy market worsened dramatically. The value of Energy's partnership units declined by between a third and a half, which caused the debt financing required for the cash portion of the consideration to become prohibitively expensive.

Thereafter, Energy's head of tax reevaluated the transaction structure upon noticing that an aspect of the transaction was different than he previously had understood. Specifically, Energy would transfer $6.05 billion in cash in exchange for its affiliate's shares having a value of approximately $2 billion, which the head of tax was concerned would trigger a taxable gain in the amount of approximately $1 billion.

Upon Energy's head of tax bringing the issue to the attention of Energy's outside tax counsel, counsel determined that it could no longer issue the opinion required as a condition to closing the merger. Williams suggested two alternative transaction structures, which Energy's tax counsel determined were inadequate for purposes of its opinion.

Williams commenced an action in the Delaware Court of Chancery seeking a declaratory judgment to estop, and an injunction to preclude, Energy from terminating the merger agreement based on (i) the failure of Energy's outside tax counsel to act in good faith when determining not to issue the tax opinion, and (ii) Energy's failure to use commercially reasonable efforts to obtain the tax opinion from its tax counsel.

With respect to the argument that Energy's outside tax counsel failed to act in good faith, the court noted that the relevant standard, which tax counsel satisfied, for purposes of issuing the tax opinion was counsel's subjective good-faith determination as to whether the relevant transaction should be a tax-free transfer. The court recognized that the national and international reputation of Energy's tax counsel gave it an incentive to avoid the "substantial embarrassment" of not issuing an opinion that it initially concluded could be provided. In addition, tax counsel spent over 1,000 hours researching and analyzing cases and regulation before reaching the conclusion that the opinion it believed could be issued at the time the merger agreement was executed could no longer be issued because of the drop in the value of Energy's partnership units.

With respect to the argument that Energy failed to use commercially reasonable efforts to obtain the opinion from its tax counsel, the court noted that the term "commercially reasonable efforts" was not defined in the merger agreement and had never been coherently interpreted in prior Delaware case law. After reviewing the Court of Chancery's opinion in *Hexion Specialty Chemicals, Inc. v. Huntsman Corp*., the court concluded that "commercially reasonable efforts" was an objective standard that required the party "to do those things objectively reasonable to produce the desired [result], in the context of the agreement between the parties."

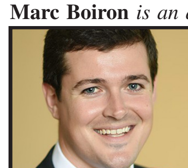
As a result of Energy's desire to terminate the merger agreement, the court was skeptical of Energy's motivation to consummate the merger. However, there were no commercially reasonable efforts that Energy could have taken to consummate the merger given that its tax counsel would not in good faith give the required tax opinion. In addition, the court found that Energy did not manipulate its tax counsel's knowledge or ability to render the tax opinion or take any other action to obstruct its tax counsel's ability to issue the opinion, even though Energy's head of tax brought to tax counsel's attention the issue that caused it to be unable to issue the opinion.

The *Energy Transfer* decision provides meaningful lessons with respect to drafting and negotiating transaction agreements. First, the meaning of the term "commercially reasonable efforts" under Delaware law has not often been analyzed by Delaware courts but the court in *Energy Transfer* provided guidelines for the interpretation of that term. The term "commercially reasonable efforts" creates an objective standard by which a party to an agreement must act. It requires a party to an agreement to do anything "objectively reasonable to produce the desired [result], in the context of the agreement reached by the parties." Although the term "commercially reasonable efforts" leaves much to be desired where parties are seeking certainty in a transaction, the court's interpretation of the term provides another marker to use when drafting a commercial agreement in which parties desire to define each other's required efforts in the transaction. Williams' appeal of the decision to the Delaware Supreme Court, may provide additional guidance on the meaning, or confirmation of the Court of Chancery's interpretation, of the term "commercially reasonable efforts" under Delaware law.

Second, parties to a merger or purchase agreement should consider the value of a legal opinion in the transaction and any unintended consequences of requiring the issuance of opinion. Parties should not treat the receipt of an opinion from counsel as a foregone conclusion. Although an opinion that counsel believes can be given at signing typically will be given at closing, there are situations, beyond those arising in *Energy Transfer*, where circumstances would change, causing legal counsel to be unable to render that opinion. For example, assume that an asset purchase agreement requires the issuance of a legal opinion stating that the asset sale is not a sale of substantially all of the corporation's assets requiring stockholder approval under Section 271 of the General Corporation Law of the State of Delaware. Assume further that one of the corporation's two businesses, which has not represented substantially all of the corporation's assets, is being sold and that between signing and closing an event disrupts the business not being sold so significantly that the business being sold would soon constitute substantially all of the corporation's assets. Although counsel believed that the opinion could be given at signing, the opinion could no longer be given at closing as a result of a material change in one of the two businesses.

Lastly, a Delaware court will likely defer to counsel's conclusion regarding its ability to deliver a legal opinion in connection with a transaction. The court should apply a subjective good-faith determination, which, subject to discovering clear evidence of an intent to thwart the transaction, would likely cause the court to defer to the counsel's conclusion regarding the issuance of its opinion.

Marc Boiron *is an associate with Rutan & Tucker LLP. You can reach him at (714) 338-1861 or mboiron@rutan.com.*


MARC BOIRON