ALERT MEMORANDUM

Tax Opinion Closing Conditions in M&A Transactions Following Delaware Litigation Over ETE/Williams's Busted Deal

March 28, 2017

On March 23, 2017, the Delaware Supreme Court affirmed the Delaware Court of Chancery's ruling that Energy Transfer Equity L.P. ("ETE") did not breach its agreement to merge with The Williams Companies, Inc. when ETE terminated the agreement on the grounds that its counsel was unwilling to deliver a tax opinion that was a closing condition to the merger.

While the court's decision has been eagerly anticipated, the larger impact of the ETE/Williams matter occurred back in May 2016 when the dispute became public: the dispute highlighted that tax-opinion closing conditions which are intended to protect the parties against tax risks could instead add to deal risks.

This Alert will briefly describe the facts in the case and the court's decision, and then turn to a survey of what deal counterparties have been doing differently to protect against "ETE/Williams risk". We end with a menu of features deal counterparties should consider using in future deals.

These features include:

— No tax opinion required

— Tax opinions prepared before signing

— Closing condition limited to change in tax law

— Obligation to accept opinion from other party's counsel or an alternate counsel

— Obligation to restructure if necessary to obtain tax opinion

— Termination fee for termination because of inability to obtain opinion

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I. ETE/Williams

In September 2015, ETE and Williams, two publicly-traded oil and gas pipeline operators, entered into a merger agreement. Somewhat simplified, the transaction was structured as ETE (a publicly-traded partnership) acquiring

- 19% of Williams's stock in exchange for $6.05 billion in cash, and
- all of the assets of Williams in exchange for a fixed number of partnership units in ETE.[1]

Thus,

- the historic Williams shareholders would end up with 81% of Williams stock and $6.05 billion in cash;
- Williams would end up with a partnership interest in ETE; and
- ETE would end up with all its historic assets, all Williams's historic assets, and 19% of Williams stock.[2]

Both parties' obligations to close were conditioned upon ETE's outside tax lawyers issuing an opinion that the contribution of assets from Williams to ETE "should" be tax-free to Williams and its shareholders. Any tax costs to Williams would have been borne, in part, by ETE, so both parties had exposure to the tax risk. Both parties represented that they knew of no facts that would reasonably be expected to prevent tax-free treatment, and they both covenanted to use "commercially reasonable efforts" to obtain the opinion and to use "reasonable best efforts" to cause all the closing conditions to be satisfied. The agreement provided that, if the closing conditions had not been met by June 28, 2016, the agreement would be terminated.

After signing and before closing, the energy market (and the value of Williams's assets) declined significantly. According to the Delaware Supreme Court, "[t]his caused the transaction to become financially undesirable to ETE" and "the record is quite clear that ETE strongly desired that the transaction not go forward."[3] Exactly how the parties reacted to this development was the subject of some dispute, but the end result was that ETE's outside tax lawyers were unwilling to issue the required tax opinion. Counsel's stated concern was that, because the Williams stock that was being acquired for $6.05 billion was now worth only $2 billion, the other $4.05 billion might be treated as being paid as part of the consideration for Williams's assets; if that were the correct characterization of what was happening, then the contribution of assets would not be tax-free to Williams.

What was particularly unusual here was that this tax risk had not been identified by the parties or their counsel prior to signing the merger agreement, and was identified only after the energy market went downhill. Williams did not agree that there was a tax risk and suspected that ETE was looking for an excuse to terminate the agreement and that ETE had not used "commercially reasonable efforts" to try to obtain the opinion, or "reasonable best efforts" to cause the closing conditions to be met. Indeed, it was undisputed that the tax risk was first identified by the

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[1] The stock-for-cash exchange was intended to be a tax-free stock issuance pursuant to Section 1032 of the Internal Revenue Code of 1986, as amended (the "Code"), and the assets-for-partnership-interests exchange was intended to be a tax-free contribution to a partnership pursuant to Section 721 of the Code.

[2] This would have been "hook stock" because Williams's only asset would have been its partnership interest in ETE. The ending structure was unusual but, had it worked, would have accomplished the goals of getting the cash to the Williams's stockholders without taxable gain at the Williams corporate level and enabling the Williams's stockholders to continue to own stock in a corporation rather than equity in a publicly traded partnership.

[3] The record before the Delaware courts—which is publicly available—included extensive internal communications amongst the parties and their lawyers, which presumably had been expected to be protected by privilege. Once the lawyers' advice and what was said to the lawyers became the subject of the dispute, all these materials were required to be produced. The matter accordingly stands as a cautionary reminder that litigation can cause internal communications to become public, even if those communications are with counsel and thus ordinarily would be privileged.

ETE tax director, who brought it to the attention of ETE's outside tax lawyers.

Williams sued, seeking a declaration that ETE had materially breached the merger agreement and an injunction preventing ETE from terminating the merger agreement. The lower court decided the case on an expedited basis and held that ETE had not breached the agreement.

The Delaware Supreme Court has now affirmed that decision, but on different grounds.[4] The Court held that the appropriate way to approach the case was:

first, Williams had the burden of proving that ETE breached its covenants to use "commercially reasonable efforts" to obtain the tax opinion and "reasonable best efforts" to close the transaction, and

second, if Williams met that burden, ETE could then defend by establishing that the breaches did not "materially contribute" to the failure of the tax opinion closing condition.[5]

The Court's decision sidestepped the question of whether ETE had, in fact, breached its affirmative obligations by concluding that (i) the lower court had found that ETE met its burden of showing that, even if there was a breach, that breach did not "materially contribute" to its tax lawyers' inability to deliver the opinion, and (ii) the lower court finding was " not clearly erroneous."[6]

Chief Justice Strine dissented: he was of the view that ETE had breached its covenants and that it was quite possible that this breach had materially contributed to the failure of the tax opinion closing condition; he would have returned the case to the lower court for a trial addressing that issue.[7]

With respect to what the covenants required from ETE, C.J. Strine and the majority agreed that "commercially reasonable efforts" and "reasonable best efforts" meant that ETE had an affirmative obligation to take reasonable steps to obtain the tax opinion. Where they disagreed was that C.J. Strine thought that ETE needed to establish affirmatively that, even if it had taken those steps, the lawyers still would not have issued the tax opinion.[8]

II. Survey of Market Responses to ETE/Williams

The ETE/Williams matter has had a significant impact on the closing conditions and pre-closing covenants in M&A agreements.

Parties negotiate for closing conditions in order to protect themselves: they do not want to be obligated to close if the deal is not the deal they bargained for.

Opinion closing conditions, in particular tax opinion closing conditions, are usually used to protect against identified risks, such as the risk of a change in law or the risk of changes in facts that are crucial to the legal conclusions.

The ETE/Williams matter highlights that a tax opinion closing condition can potentially have the perverse effect of adding to deal risk when the other party is looking for a way out of the deal. For example, a condition that is met only if one specified law firm is willing to issue the opinion is more vulnerable than a condition that could be met by the opinion of alternate counsel.

Our review of the terms of public transactions signed since the ETE/Williams matter first surfaced shows that parties have started using deal features that appear intended to mitigate the risk highlighted by ETE/Williams.

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[4] *The Williams Companies, Inc. v. Energy Transfer Equity, L.P.*, No. 330, 2016, slip op. (Del. S. Ct. March 23, 2017) (hereinafter "Majority Opinion").

[5] Majority Opinion at 19 (citing Restatement (Second) of Contracts § 245).

[6] Majority Opinion at 21. The Chancery Court's finding was in a footnote that explained that if ETE had a burden, it was met because "the record is barren of any indication that the action or inaction of [ETE]… contributed materially to" counsel's inability to issue the opinion.

[7] C.J. Strine's dissent appears to have been significantly influenced by his review of some of the internal communications in the record (see footnote 3).

[8] Unlike the majority, C.J. Strine did not view the lack of evidence of causation in the record as meeting this burden.

1. No tax opinions required.

In two public mergers, the parties have completely dispensed with tax opinion closing conditions, clearly in response to ETE/Williams. The deals take different approaches: one providing for opinions to be obtained but having no consequences if they are not, and the other not even mentioning tax opinions.

— *AT&T, Inc.'s acquisition of Time Warner, Inc. (signed October 22, 2016)*

- Both parties represent (as of signing, not closing) that they are not aware of any facts or circumstances, and have not taken or agreed to take any action, that would (or would be reasonably likely to) prevent or impede the intended tax-free treatment.
  - Target also represents that it has consulted with its tax counsel and has full knowledge of the terms of the merger agreement.
- Both parties covenant not to take or fail to take any action that would reasonably be likely to prevent or impede the intended tax-free treatment, and to notify the other party if it becomes aware of any non-public fact or circumstance that would reasonably be likely to prevent or impede the intended tax-free treatment.
- If target's counsel cannot deliver a tax opinion before closing, the parties will cooperate in good faith to explore alternative structures, but failure to agree upon an alternative structure (or obtain a tax opinion) will not prevent closing.

— *Enbridge, Inc.'s acquisition of Spectra Energy Corp. (signed September 5, 2016)*

- Each party represents that, after due inquiry and consultation with its counsel, it is not aware of any fact that would reasonably be expected to prevent tax-free treatment.
- Each party covenants not to take any action that would reasonably be expected to prevent tax-free treatment.
- But no obligations to provide representation letters and no mention of seeking or obtaining tax opinions.

2. Text of tax opinions and representation letters are agreed to before signing.

— *Windstream Holdings, Inc.'s acquisition of Earthlink Holdings Corp. (signed November 5, 2016)*

- Closing condition that each party receives tax opinion from its own counsel, but the form of the opinions and the representation letters are attached to the merger agreement at signing.
- Target represents that it has not taken any action, and does not know of any fact, agreement, plan or other circumstance, that is reasonably likely to prevent the merger from qualifying as tax-free.
- Both parties covenant (a) not to take or cause to be taken any action that would result in the merger being taxable, (b) to use commercially reasonable efforts to cause the merger to qualify as tax-free, and (c) to cooperate with each other and with counsel in obtaining tax opinions, including by providing the representation letters at closing.

3. Text of tax opinions and representation letters are agreed to before signing, and alternate counsel is identified at signing.

— *Rockwell Collins acquisition of B/E Aerospace, Inc. (signed October 23, 2016)*

- There is a closing condition that each party receives a tax opinion from its own counsel, but the forms of the opinions and representation letters are attached to the merger agreement at signing.
- If either counsel will not deliver the opinion, the closing condition can be satisfied instead by the opinion from the other party's counsel plus an opinion from alternate counsel (who was agreed upon at signing).

- The parties also included special termination provisions:
  - The target would pay a termination fee of $200 million (plus fees and expenses) if the acquiror terminated because the tax opinion closing condition was not met and the target's signing date representation letter was inaccurate.
  - The acquiror would pay a termination fee of $300 million (plus fees and expenses) if the target terminated because the tax opinion closing condition was not met and the acquiror's signing date representation letter was inaccurate.

4. **Tax opinions are required at closing, but if a party's chosen advisor is unwilling to issue the opinion, the party must accept the opinion issued by the counterparty's advisor; plus acquirer pays termination fee if opinions not issued.**

— *MacDonald, Dettwiler and Associates, Ltd.'s acquisition of DigitalGlobe, Inc. (signed February 24, 2017).*

- Each party's obligation to close is conditioned upon receipt of tax opinion from its own advisors, but if its advisors will not deliver the opinion, the party is required to accept an opinion from the other party's tax advisors, but only if that other opinion is provided by the specific law firm or the specific accounting firm named in the merger agreement or a third firm agreed to by both parties.
- For this purpose, the parties agree up front to each other's advisors (two options for each party), and to substitute a third alternative advisor if the first two will not issue the opinion.
- If the agreement is terminated by the target because none of the specified counsel was willing to issue the opinion, the acquirer is required to pay a significant reverse termination fee.

5. **Tax opinions are required at closing, but acquiror's obligations are conditioned on it receiving both opinions.**

— *Entercom Communications Corp.'s acquisition of CBS Radio, Inc. (signed February 2, 2017).*[9]

- Each party receives a tax opinion from its own advisor, and the acquiror also receives the target's tax opinion.
- In addition, exchange ratios will be "trued-up" if necessary to prevent a pre-transaction reorganization by the target from becoming taxable.

6. **Covenant to try to restructure, if necessary.**

— *Yadkin Financial Corporation's acquisition of F.N.B. Corporation (signed July 20, 2016).*

- Each party covenants to use reasonable best efforts to cause the merger to be tax-free, including by:
  - not taking any action that it knows would reasonably be likely to prevent such qualification, and
  - considering and negotiating in good faith any amendments to the merger agreement that may reasonably be required in order to obtain such qualification (it being understood that neither party will be required to agree to any such amendment).

[9] It is unclear whether the terms of this agreement reflect a reaction to ETE/Williams, or simply the specific facts of the transaction.

III. Features That Can Be Used to Decrease ETE/Williams Risk

Why have a tax opinion closing condition at all?

— Before closing, each party wants assurances that the tax treatment will be what it expected at signing. The tax treatment may be affected by:
  - changes in law, or
  - changes in fact.

— Neither party wants to enable the counterparty to use the tax opinion closing condition as an excuse to terminate the deal.
  - If a party's appetite for tax risk has changed, that should not be an opportunity to terminate the deal.
  - If a party has not realized the full extent of tax risk before it signed, whether that should be an appropriate reason to terminate the deal will depend upon the particular facts of the transaction and the nature of the mistake.

Menu of Protective Features

Listed below are different features that can be added, individually or in combination, to M&A agreements to minimize "ETE/Williams" risk:

— Have no tax opinion (or other tax-related) closing conditions.[10]

— Require that tax opinions be delivered at signing (or that the text be agreed upon prior to signing).[11]

— Require that representation letters be delivered at signing (or that the text be agreed upon prior to signing).[12]

— Limit closing condition to no change in law that would impact tax opinions.

— Limit closing condition to no changes in specified facts that are crucial to tax opinions (such as relative values of companies).

— Require counterparty to accept opinion from your counsel if theirs will not issue the opinion.[13]

— Require counterparty to accept opinion from a third-party alternative counsel if theirs will not issue the opinion.

— Termination fee if refusal to close is due to failure to obtain tax opinion.

— Covenant to restructure the transaction if the opinion cannot be issued.
  - Agree to use alternative counsel to assist in coming to an agreement regarding a new structure.
  - Agree at signing to alternative structures that provide the desired tax treatment.

— Extend the termination date automatically while the deal is restructured or other work is done to obtain the opinion.

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[10] May want to combine with a closing condition that there has been no change in tax law or in specified facts.

[11] May want to combine with a closing condition that there has been no change in tax law or in specified facts. Even if opinions are not finalized until closing, requiring that the text be agreed upon prior to signing should significantly reduce the ETE/Williams risk.

[12] Focuses the parties on identifying the significant facts and ensures that the parties are willing to represent to them.

[13] This may be unattractive to a party that expects to rely upon the opinion, since the party might reasonably be reluctant to rely on any opinion after its preferred counsel refused to provide the opinion.