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Delaware Court Refuses to Enjoin Buyer From Terminating Merger Agreement Due to Failure of Closing Condition

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Analyzes interplay between buyer's covenant to use "reasonable best efforts" to consummate transaction and non-satisfaction of closing condition

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INTRODUCTION

In the M&A world, buyers and sellers are not required to consummate (or "close") the transactions contemplated by their acquisition agreements unless the negotiated closing conditions are satisfied.[1] Closing conditions, therefore, allocate various risks that arise between signing and closing—some of which are known at the time of signing[2] and others of which may come as a surprise[3]—between the parties. When a condition to a buyer's obligation to close is not satisfied, the buyer has the power to delay, seek a renegotiation and, ultimately, derail the transaction. For this reason, sellers generally, and particularly those engaged in public M&A, seek to both (1) limit closing conditions to those absolutely required and (2) avoid closing conditions over which the buyer is able to exercise a degree of control.

Of course, the failure of a closing condition alone does not mean that one of the parties is liable to the other for breach of the agreement. Closing conditions serve merely as a proverbial gate that must be lifted before the parties can proceed to the promised land of closing. But if the actions or inactions of one of the parties has caused the failure of a closing condition, there will be an inquiry into whether that party (1) breached one or more of its representations and warranties or (2) failed to satisfy an affirmative or negative pre-closing covenant. Depending on the materiality of the breach, its relationship to the failure of the closing condition, and the mindset of the breaching party, liability under the acquisition agreement for damages may result. Further, a buyer's failure to comply with its contractual commitments could be a factor in convincing a court to grant equitable relief to a seller left standing at the altar.

There are several relatively recent Delaware court decisions addressing the impact of failures of closing conditions on pending M&A transactions.[4] For instance, in *Hexion Specialty Chemicals, Inc. v.*

1. Alternatively, where permissible, closing conditions can be waived.

2. For example, this might include required regulatory and corporate approvals and acquisition financing requirements.

3. For example, this might include intervening developments adversely impacting the economy or the industry in which the seller operates in general or the seller's business in particular.

4. The seminal case in this area is *In Re IBP, Inc. S'holders Litig.*, 789 A.2d 14 (Del. Ch. 2001), in which then-Vice Chancellor Leo E. Strine, Jr. ordered Tyson, Inc. ("Tyson") to complete its contractually-agreed upon acquisition of IBP, Inc. ("IBP") despite Tyson's claim that IBP had

Huntsman Corp.,[5] the Delaware Court of Chancery (the "*Chancery Court*") faced a claim by a target company that its buyer, who had soured on the acquisition in the face of deteriorating economic conditions, was seeking to take advantage of a closing condition tied to its receipt of acquisition financing. The target company alleged that the buyer failed to use its "reasonable best efforts," as required by the merger agreement, to secure the necessary financing. The Chancery Court granted equitable relief to the target company, ordering the buyer to employ the degree of efforts called for by the merger agreement's financing covenants.

Notwithstanding *Hexion*, a pre-closing covenant requiring buyer to use "commercially reasonable efforts" or "reasonable best efforts" does not guarantee that a court will provide relief to a target company when its buyer seeks to avoid an unfavorable transaction due to failure of a closing condition. This is indeed a fact-sensitive determination. In *The Williams Companies, Inc. v. Energy Transfer Equity, L.P.*,[6] the Chancery Court, in dismissing a target company's claim that its buyer failed to use the degree of efforts required by the merger agreement to obtain an opinion from its tax counsel, distinguished *Hexion*. The Delaware Supreme Court (the "*Supreme Court*"), despite a rare dissenting opinion from Chief Justice Leo E. Strine, Jr., affirmed. Both Courts concluded that, even though the record indicated that the buyer was disinclined to proceed with the transaction due to adverse post-signing developments in the energy industry, there was no linkage between the alleged lack of effort employed by the buyer and its tax counsel's refusal to deliver the required opinion.

I. FACTUAL BACKGROUND

A. ETE and Williams Sign a Merger Agreement

The Williams Companies, Inc. ("*Williams*") and Energy Transfer Equity, L.P. ("*ETE*") both "are involved in the gas pipeline business."[7] In September 2015, ETE agreed to acquire Williams in a merger agreement calling for a two-step transaction (the "*Merger Agreement*"). In the first step, Williams would merge into a new entity, Energy

suffered a material adverse change to its business post-signing, concluding that Tyson's claims were a pretext for a serious case of "buyer's remorse."

5. 965 A.2d 715 (Del. Ch. 2008) (hereinafter referred to as "*Hexion*").

6. C.A. No. 12337-VCG, 2016 WL 3576682 (Del. Ch. June 24, 2016), *aff'd* 159 A.3d 264 (Del. March 23, 2017) [hereinafter referred to as "*Williams*"].

7. *Williams*, 159 A.3d at 266.

Transfer Corp, L.P. ("ETC"), formed by ETE (the "*Merger*"). In the Merger, Williams stockholders would receive $6.05 billion in cash and an 81% equity interest in ETC, with ETE retaining the remaining 19%. In the second step, ETC would transfer Williams' assets to ETE in return for newly issued partnership units.

The structure of the deal was highly influenced by tax considerations. Specifically, ETE wished to avoid taxable gain on the acquisition of Williams' assets. To amplify ETE's desire to optimize the tax benefits of the transaction, the Merger Agreement conditioned ETE's obligation to complete the transaction on ETE's tax counsel, Latham & Watkins LLP ("*Latham*"), issuing an opinion that the transfer of Williams' assets to ETE "should" be tax-free (the "*Opinion*").[8] Additionally, the Merger Agreement included two post-signing covenants (the "*Covenants*") obligating the parties "to use 'commercially reasonable efforts' to obtain the . . . opinion and to use 'reasonable best efforts' to consummate the transaction."[9] Apparently, when "the parties entered into the Merger Agreement, the parties and their tax advisors all believed that the second step of the transaction would qualify as tax free . . . ."[10]

B. Latham Refuses to Deliver Tax Opinion

Following signing, "the energy market suffered a severe decline which caused a significant loss in the value of assets of the type held by Williams and ETE," causing "the transaction to become financially undesirable to ETE."[11] ETE, doubting its ability to raise the $6.05 billion necessary to meet its obligations under the Merger Agreement, "strongly desired that the transaction not go forward."[12]

This decline in value also apparently caused ETE's Head of Tax to become concerned that the Internal Revenue Service ("IRS") would collapse the two steps of the transaction, thereby triggering recognition of gain on the transfer of Williams' assets in the second step. In March 2016, he raised this concern with Latham. Although Latham previously had not considered the impact of a decline in the value of the businesses on its ability to render the Opinion, after further review, Latham notified ETE that it could not issue the Opinion. A second tax counsel retained by ETE to analyze the issue concurred with Latham. Latham then communicated its position to Williams' tax counsel, Cravath,

8. *Id.* at 266–7.
9. *Id* at 267.
10. *Id.* at 268.
11. *Id.* at 267.
12. *Id.* at 268.

Swaine & Moore LLP ("*Cravath*"). Cravath disagreed with Latham's determination, but offered two potential solutions. When Latham responded that neither proposal would permit it to deliver the Opinion, ETE publicly disclosed that the closing condition tied to the Opinion would not be satisfied.

C. Litigation Ensues

On May 13, 2016, Williams asked the Chancery Court "to enjoin ETE from terminating the Merger Agreement" on the basis of Latham's unwillingness to render the Opinion.[13] Williams believed that Latham's decision not to issue the Opinion was a pretext grounded in ETE's desire to terminate the transaction due to the upheaval in the energy markets, and claimed that ETE breached the Covenants by failing to exercise the required degree of efforts to resolve the tax issue. Williams also alleged that ETE should be estopped from terminating the Merger Agreement because it misrepresented in the Merger Agreement "that it knew of no facts that would prevent the second step of the transaction from being treated as tax-free at the time the parties entered into the agreement."[14]

The Chancery Court refused to grant Williams' requested injunction. First, the Chancery Court found that Latham acted "independently and in good faith" when it decided not to issue the Opinion.[15] In support of this conclusion, the Chancery Court noted that "Latham's ultimate refusal to issue the . . . [O]pinion went against its reputational interests."[16] Next, the Chancery Court "observed that the record did not reflect any affirmative acts taken by ETE to mislead Latham and prevent the issuance of the . . . [O]pinion."[17] Lastly, the Chancery Court ruled that ETE had not breached any of its representations and warranties "at the time of signing" of the Merger Agreement.[18] Williams' timely appeal to the Supreme Court followed.

II. THE SUPREME COURT MAJORITY'S ANALYSIS

A. Hexion Imposes Affirmative Obligations on Contracting Parties

On behalf of the Supreme Court majority, Justice James T. Vaughn, Jr. addressed Williams' first contention on appeal that the

13. *Id.* at 267.
14. *Id.*
15. *Id.* at 270.
16. *Id.*
17. *Id.* at 271.
18. *Id.*

Chancery Court misinterpreted *Hexion* by finding that " 'commercially reasonable efforts' and 'reasonable best efforts' . . . impos[ed] only a negative duty not to thwart or obstruct performance of the Agreement, rather than an affirmative duty to help ensure performance."[19] The majority agreed with Williams that the Chancery Court "took an unduly narrow view of *Hexion*," opining that *Hexion* "recognized that covenants like the ones involved here impose obligations to take all reasonable steps to solve problems and consummate the transaction."[20]

Justice Vaughn also found the plain language of the Merger Agreement to be consistent with this interpretation of *Hexion*. The operative "language not only prohibited the parties from preventing the [M]erger, but obligated the parties to take all reasonable actions to complete the [M]erger."[21] For instance, Section 5.03 required the parties to "us[e] reasonable best efforts to accomplish the . . . *taking of all acts* necessary to cause the conditions to Closing to be satisfied as promptly as practicable."[22]

Against this backdrop, the majority concluded that the Chancery Court "erred here by focusing on the absence of any evidence to show that ETE caused Latham to withhold the . . . [O]pinion."[23] Looking to the record established in the Chancery Court proceedings, Justice Vaughn reasoned that the lower court "could have concluded that ETE did breach its covenants."[24] Specifically, "ETE 'did not direct Latham to . . . engage with Williams' counsel, failed itself to negotiate the issue directly with Williams, failed to coordinate a response among the various players, [and] went public with the information that Latham had declined to issue the . . . Opinion.'"[25] All in all, ETE "generally did not act like an enthusiastic partner in pursuit of consummation of the Merger."[26]

B. Burden of Proving Causation

Next, Justice Vaughn explained that "once a breach of a covenant is established, the burden is on the breaching party to show that the breach did not materially contribute to the failure of the

19. *Id.* at 272.
20. *Id.*
21. *Id.* at 273.
22. *Id.*
23. *Id.*
24. *Id.*
25. *Id.*
26. *Id.*

transaction."[27] The Justice found, however, that the Chancery Court "appears to improperly place that burden upon Williams with comments such as . . . 'Williams can point to no commercially reasonable efforts that [ETE] could have taken to consummate the [M]erger . . . .' "[28]

Nevertheless, Justice Vaughn turned to a footnote in the Chancery Court's opinion stating "that the record is barren of any indication that the action or inaction of [ETE] (other than simply drawing Latham's attention to the problem) contributed materially to Latham's inability to issue the . . . Opinion."[29] For the majority, this statement indicated that the Chancery Court actually did consider what would have been the effect of shifting the burden to ETE and, in that connection, did not change its ultimate conclusion that ETE's actions did not lead to the failure of the Opinion condition.

C. Estoppel by Misrepresentation

In response to Williams' final challenge, Justice Vaughn found that "ETE did not fail to disclose any facts known to it at the time the agreement was signed."[30] Instead, it was Latham's "theory of tax liability" that changed post-signing.[31] In response to Williams' contention that "ETE conveniently pointed out the potential tax issue to Latham as a way to terminate the agreement once it became financially undesirable to ETE," the Justice observed "there is nothing to indicate that ETE knew of this potentially problematic theory of tax liability at the time it made its representations and chose not to disclose it to Williams."[32] On this basis, the majority rejected Williams' estoppel claim, finding that ETE had not breached its representations and warranties in the Merger Agreement.

III. CHIEF JUSTICE STRINE'S DISSENT

Chief Justice Strine agreed with the majority's critique of the Chancery Court's analysis of the Covenants, but took a more jaundiced view of the facts underlying Latham's decision not to issue the Opinion. Noting that "ETE's suspicious behavior really only got going . . . after

27. *Id.*
28. *Id.* at 273–4.
29. *Id.* at 274.
30. *Id.* at 275.
31. *Id.*
32. *Id.*

the energy markets . . . materially deteriorated," the Chief Justice saw the important question as not "*whether* the person I will call the 'Latham Tax Lawyer' was honest when he said he could not give the required tax opinion," but rather "*why* the Latham Tax Lawyer did not give the required opinion."[33]

In particular, the Chief Justice opined that both the Supreme Court majority and the Chancery Court gave improper deference to the Latham lawyer's state of mind rather than employing an objective reasonableness standard. Rather than accepting the Latham lawyer's testimony as proof of good faith and crediting Latham's reputational interests, the Chief Justice reasoned, the Courts should have considered the possibility of undue pressure from Latham's client, ETE, as well as (1) ETE's preference for terminating the Merger Agreement rather than renegotiating the deal terms to eliminate the tax issue;[34] (2) the fact that ETE's tax director flagged the Opinion issue for Latham; (3) ETE's direction that Latham delay advising Cravath of its concerns; (4) Latham's dismissal of Cravath's suggestions for rectifying the situation; and (5) ETE's public disclosure of Latham's reluctance to deliver the Opinion before Latham had an opportunity to fully discuss its concerns with Williams' counsel.

On this basis, rather than affirming the Chancery Court ruling, Chief Justice Strine would have required "a new trial at which ETE would be required to prove that its breach [of the Covenants] did not materially contribute to the failure of the Latham Tax Lawyer to deliver the . . . Opinion."[35] From the Chief Justice's point of view, when "you breach your obligation to help a condition come about, you do not get credit for rigging the game."[36]

CONCLUSION

The *Williams* courts' decision not to provide the requested relief exemplifies why sellers generally, and particularly target companies in public M&A transactions, arduously seek to limit buyers' ability to decline to consummate the transaction as negotiated. Of course, in a transaction intricately structured to drive a favorable tax outcome, tax opinions from the respective parties' tax counsel frequently are a

33. *Id.* at 276 (emphasis added).

34. According to Chief Justice Strine, a relatively straightforward amendment to the Merger consideration would have rectified the tax issue with "no material economic effect on ETE." *Id.* at 284.

35. *Id.*

36. *Id.*

prerequisite to the parties' obligations to close.[37] While the target company in such a tax-driven transaction will seek to negotiate covenants requiring a reasonable degree of effort on buyer's part to obtain the opinion, *Williams* demonstrates that such covenants by no means assure a favorable outcome, even in situations in which intervening events indicate that "buyer's remorse" may have driven the outcome.

From the practitioner's point of view, it is also interesting to note the Chancery Court's discussion of oft-used standards of conduct frequently employed in M&A agreements. *First*, the Chancery Court noted that it was unaware of any case law explaining the meaning of "commercially reasonable efforts."[38] *Second*, the Chancery Court, relying on *Hexion*, "equated 'reasonable best efforts' with good faith.' "[39] And, *third*, again quoting from *Hexion*, the Chancery Court noted that " 'reasonable best efforts' was similar to 'commercially reasonable efforts.' "[40] This explanation points to some degree of circularity in the manner in which Delaware courts will approach these important concepts. While it may not matter which of these concepts is employed in any given commercial agreement, practitioners still should think twice before indiscriminately using *both* terms in the same agreement.

POST-SCRIPT

Following ETE's termination of the Merger Agreement due to the failure of the Opinion condition, the parties pursued damages claims against each other in the Chancery Court.[41] For its part, ETE sought payment from Williams of a $1 billion breakup fee under the Merger Agreement, arguing that Williams had breached various sections of the Merger Agreement. On December 1, 2017, the Chancery Court rejected ETE's arguments. In so ruling, the Chancery Court explained that "none of the allegations of breach supporting ETE's entitlement to the breakup fee caused, or even relate to, ETE's exercise

37. Generally speaking, time is of the essence and it therefore is impractical for the parties to wait to see if the IRS will issue a favorable revenue ruling. A possible fallback position might be to demand a neutral tax counsel's opinion, either in the first instance or if the parties' respective counsel cannot agree, but buyers generally are reluctant to rely on a counsel not intimately familiar with the buyer and its tax profile.

38. *Id*. at 271.

39. *Id.*

40. *Id.*

41. The Williams Companies, Inc. v. Energy Transfer Equity, L.P., C.A. No. 12337-VCG, 2017 WL 5953513 (Del. Ch. Dec. 1, 2017).

of its right to avoid the merger" due to Latham's failure to deliver the Opinion.[42]

42. *Id*. at *1.