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Hook Stock Torpedoes "Should" Opinion, Buyer Scuttles Mega-Merger

By Donald P. Board • Wood LLP

It is no secret that taxes can make or break even the biggest M & A deals. The combination of two enterprises may make all the business sense in the world. But, if the acquisition cannot pass tax muster, it will never make it off the drawing board.

So we do not often catch taxes (or tax professionals!) in the act of "breaking" an actually pending M & A transaction. The headline-grabbing exception is when there is a change in the tax law during the awkward period between signing and closing. In public-company deals, the window of vulnerability can extend for months as the parties work to obtain shareholder approvals and regulatory clearances. Just ask Pfizer and Allergan.

In November 2015, the two pharmaceutical giants agreed to a historic $160 billion merger. The deal was carefully structured to avoid triggering the anti-inversion rules of Code Sec. 7874. Moreover, as all looked good, it was on track to close in the second half of 2016.

The Treasury, however, had other ideas. On April 4, 2016, it amended the regulations under Code Sec. 7874, so that the pending merger would have triggered the anti-inversion rules after all. Two days later, the deal was dead. [*See* Donald P. Board, *Cardtronics, Terex, Johnson Controls and Pfizer Face Anti-Inversion Regulations*, 24 THE M & A TAX REPORT 1 (June 2016).] Like Jacob Marley, dead as a doornail.

An acquisition can also go south when what changes is not the tax law, but rather how one of the parties (or its tax adviser) *thinks* the law will apply to the pending transaction. The recent decision of the Delaware Court of Chancery in *The Williams Companies, Inc. v. Energy Transfer Equity, L.P.* [2016 WL 3576682, June 24, 2016] provides a rare but memorable example from the highest reaches of M & A practice.

Of course, tax professionals know that opinions can differ, sometimes materially. Yet in *Williams*, the buyer was permitted to back out a multi-billion-dollar deal that had turned into an economic disaster. The reason? The buyer's own tax counsel had determined—six months *after* the papers were signed—that it would not be able to provide a required opinion that part of the deal "should" qualify as a tax-free contribution to a partnership under Code Sec. 721(a).

The result in *Williams* is particularly striking because the court knew that the buyer was desperate to get out of the deal for reasons having nothing to do with taxes. But, as the court observed, "even a desperate man can be an honest winner of the lottery."

Pipelines Hooking Up

The Williams Companies, Inc. ("Williams") and Energy Transfer Equity, L.P. ("ETE") are not exactly household names. But they are two of the leading players in the natural gas pipeline business. And that is a big business. On September 28, 2015, they agreed that ETE would acquire Williams in a $32 billion deal.

Structuring the acquisition, however, posed significant tax challenges. Williams is a corporation. ETE, on the other hand, is a master limited partnership—a publicly traded partnership that has managed to retain its partnership status under Code Sec. 7704.

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Merging Williams into ETE was a nonstarter. A merger would not have qualified as a reorganization under Code Sec. 368(a) because ETE is a partnership. Instead, the transaction would have been treated as: (1) a contribution of Williams' assets to ETE in exchange for partnership units, followed by (2) a liquidating distribution of those units to Williams' shareholders.

Williams' contribution *could* have qualified under Code Sec. 721(a). However, the deemed distribution of ETE partnership units to Williams' shareholders would have triggered corporate-level gain under Code Sec. 336. Williams might as well have sold its assets for cash.

Corporate Three-Step

Williams and ETE wanted to avoid a taxable asset transfer, so they opted for a different approach. Their tax counsel divided the acquisition into three steps.

In the first step (the "Merger"), Williams was to merge into Energy Transfer Corp LP ("ET Corp"), a newly organized affiliate of ETE. Although ET Corp is a limited partnership, it is classified as a corporation for tax purposes. Under the terms of the Merger, Williams' shareholders were to receive not only 81 percent of ET Corp's stock but also $6 billion in cash.

The cash would have represented less than 20 percent of the total consideration when the deal was signed, so the Merger was expected to qualify as a reorganization under Code Sec. 368(a)(1)(A). Williams' transfer of its assets to ET Corp would therefore have escaped corporate-level tax pursuant to Code Sec. 361.

The $6 billion in boot would have had tax consequences, but only at the shareholder level. Gain realized on the exchange of shares would have been taxable to the extent of any cash received [Code Sec. 356]. So far, so good.

The second step was intended to get Williams' assets out of ET Corp and into the hands of ETE. Combining the two businesses was expected to produce operating synergies worth a healthy $2 billion per year.

To bring this about, ET Corp was to contribute Williams' assets to ETE in exchange for partnership units (the "Contribution").

To avoid triggering corporate-level tax, the Contribution would need to qualify under Code Sec. 721(a). An initial review by ETE's tax counsel (Latham & Watkins) indicated this would not be a problem. So nobody worried about a provision in the merger agreement giving both sides the right to walk away if Latham did not opine that the Contribution "should" qualify under Code Sec. 721(a). Again, so far, so good.

The third step was designed to provide ET Corp with the cash it would need to pay out in the Merger. ET Corp would issue 19 percent of its shares (the "Hook Stock") to ETE for $6 billion. Based on conditions prevailing on September 28, 2015, $6 billion seemed like a reasonable price.

Pipelines Down the Tube

Thanks to the worldwide oil glut, pipeline companies started to falter in the second half of 2015. Williams' stock was trading as high as $58 a share on July 10, 2015. It had fallen to about $37 when the deal was signed on September 28.

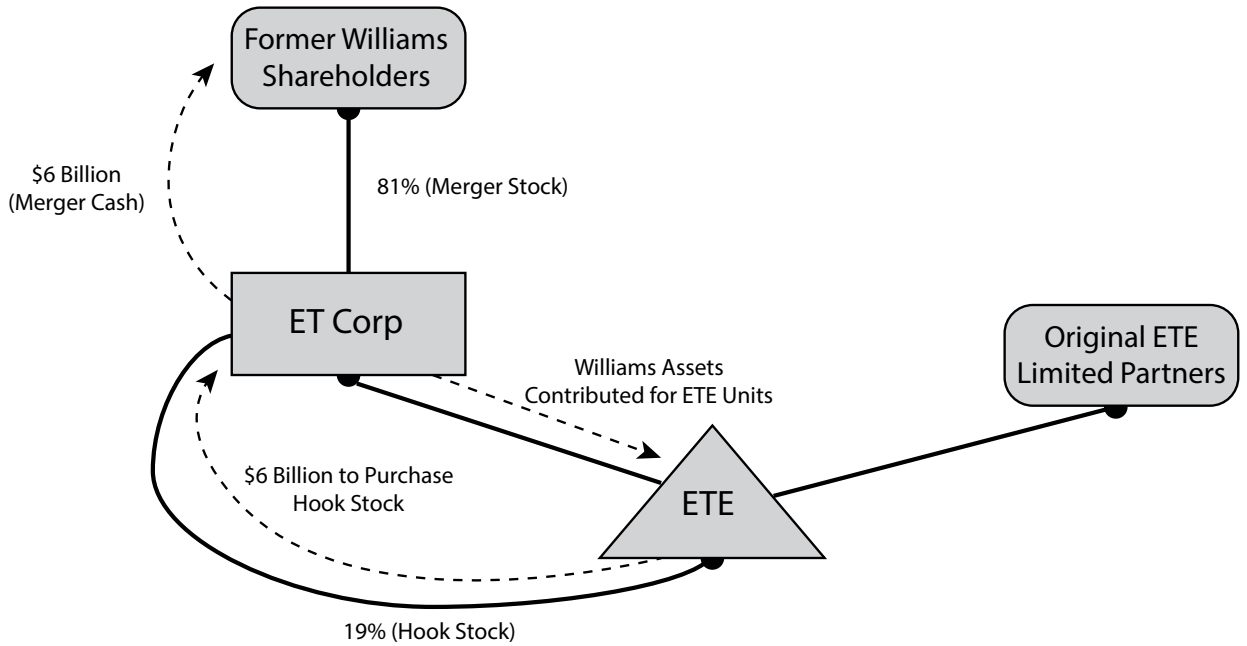
Yet if ETE thought it was buying at the bottom, it was wrong. By February 2016, Williams' stock was down to $11 per share—a 70-percent decline in just over four months. That is pretty dire, but things were even worse over at ETE. The price of ETE units dropped a gut-wrenching 83 percent during the same period. The predicted $2 billion in annual operating synergies was scaled back to a paltry $170 million—a reduction of more than 90 percent.

In a pure stock deal with a fixed exchange ratio, a highly correlated decline in the values of the target and acquirer is not the end of the world. The target may be worth a lot less, but so are the shares the buyer is using to pay for it.

Adding a fixed cash component, however, created a separate and not equal problem. ETE had agreed to purchase a fixed 19-percent interest in ET Corp (the Hook Stock) for a fixed $6 billion in cash. ET Corp had agreed to distribute the $6 billion to Williams' shareholders in the Merger. This would have left ET Corp holding no assets, post-Contribution, other than units of ETE.

This means that the Hook Stock would have been nothing more than an indirect interest in the combined assets of Williams and ETE. Thus, the steep decline in the value of the two pipeline businesses caused a sharp drop in the anticipated value of the shares of ET Corp. In March 2016, the prospective value of the Hook Stock was only about $2 billion. That

Figure 1. Transactions Following Merger



may be real money, but it was a whopping $4 billion *less* than ETE was obligated to pay for the shares.

Faced with these numbers, ETE experienced what the Court of Chancery called "a bitter buyer's remorse." Bitter indeed. ETE asked to terminate the acquisition or renegotiate its terms. But Williams was not interested. A deal is a deal.

Tax Epiphany

In late March, ETE's internal Head of Tax started thinking about the tax implications of the pending $4 billion overpayment. He would later testify that he had not thought about those implications earlier, because it was only in March that he had realized that the Hook Stock represented a *fixed* percentage of ET Corp's shares.

On March 29, the Head of Tax got in touch with Latham. After confirming his new understanding of the deal terms, he asked Latham to consider a potential tax issue he had spotted.

Suppose, he said, that ETE wound up paying ET Corp $4 billion more than the fair market value of the Hook Stock. Could the IRS argue that the $4 billion was not really paid for the shares, but rather as part of the consideration for Williams' assets? If so, he asked, would Latham still be comfortable opining that the Contribution "should" qualify under Code Sec. 721(a)? Hmmm, let's see … .

Sale in Disguise?

Tax professionals are used to thinking about form, substance and going beneath the surface to see what is what. One reason is the disguised sale rules. Under Code Sec. 707(a), a partner's contribution of property to a partnership is taxed as a sale to the extent that: (1) the contribution is combined with a transfer of "money or other consideration" by the partnership back to the contributing partner; and (2) this transfer to the partner would not have been made but for the partner's contribution to the partnership [Reg. §1.707-3(b)(1)(i)].

The question for Latham was whether the IRS could treat the $4 billion overpayment for the Hook Stock as part of a disguised sale of the Williams assets to ETE. If so, ET Corp would have to recognize gain as if it had sold ETE a $4 billion slice of the Williams assets for cash.

Eye of Beholder?

Before the deal was signed, Latham had said it would be "fairly straightforward" to opine that the Contribution would be tax-free. The firm was still expecting to render a "should" opinion in late March. But that was then.

In response to the Head of Tax's call, Latham began an intensive review of the pending transaction. At its root was worry about the effect of the massive decline in the value of the Hook Stock since the signing date. This was no cursory look-see. Latham ultimately devoted 1,000 attorney-hours to the review.

As early as April 11, 2016, however, Latham informed ETE that it would *not* be able to render a "should" opinion on the Contribution unless the value of the Hook Stock bounced back. Latham delivered the bad news to Williams' tax counsel (Cravath Swaine & Moore) the following day.

In the meantime, ETE's Head of Tax had reached out to a former colleague, William McKee (Morgan Lewis & Bockius), to get a "fresh look" at the situation. Mr. McKee is a co-author of the leading treatise on partnership taxation and a seasoned practitioner. His analysis of the disguised-sale issue would carry considerable weight.

Morgan Lewis considered the tax issues independently, without consulting with Latham. But it, too, concluded that it would not be able to deliver a "should" opinion. Morgan Lewis's conclusion, unlike Latham's, did not hinge on a decline in value of the Hook Stock.

In that respect, Morgan Lewis was considerably more pessimistic. Morgan Lewis said that there was a risk that the Contribution, combined with ETE's purchase of the Hook Stock, would be treated as a disguised sale *regardless* of the value of the shares at closing.

Williams' lawyers at Cravath were not persuaded. They asked Cravath's co-counsel on the deal (Gibson, Dunn & Crutcher) what it thought about the Contribution. Gibson initially responded that it would be "tough to get to a should" on the Code Sec. 721(a) issue. However, the firm eventually concluded that it could, if asked, render a "weak-should" opinion.

Williams Goes to Chancery

ETE promptly notified investors that Latham might not be able to provide the tax opinion

that was a condition precedent to its duty to close. Too bad, but taxes are taxes. On May 13, Williams responded by suing ETE and ET Corp in the Delaware Court of Chancery.

Williams charged that ETE had violated the merger agreement by failing to use "commercially reasonable efforts" to obtain the required tax opinion. Williams asked for a permanent injunction to prevent ETE from refusing to close based on Latham's refusal to opine.

Trying Latham's Good Faith

The drop-dead date for the transaction was June 28, 2016. The court put the litigation on an expedited schedule, culminating in a two-day trial. Vice Chancellor Glasscock heard testimony from the principal tax and corporate lawyers on the deal, as well as academic experts on partnership tax.

The court framed the case in contractual terms. Williams and ETE were sophisticated companies and they had expressly agreed that their duty to close was contingent on receipt of a "should" tax opinion from a specific law firm—Latham.

If Williams was uncomfortable with the fact that Latham represented ETE, the court observed, it should have signed a different contract. The parties' bargain would be enforced as written. Well, unless Williams persuaded the court that Latham had acted in *bad faith* when it declined to bless the Contribution.

The trial was therefore an inquiry into Latham's *bona fides*. No lawyer wants to be at the center of that kind of inquiry. As it happened, though, the Vice Chancellor was impressed by Latham's tax lawyers. They testified convincingly that they would never allow their professional judgment to be affected by a client's economic interest in getting out of a bad deal.

The Vice Chancellor also emphasized that Latham's lawyers were "obviously embarrassed" that they had failed to consider how changing economic conditions might affect their initial analysis under Code Sec. 721(a). Backtracking on the tax opinion had tarnished Latham's professional reputation and their own. In the court's view, these adverse reputational effects would "surely outweigh any benefit of an unethical deference to the interests of [ETE]."

Williams' expert witness (a law professor) launched a blistering attack on Latham's analysis. In his view, Latham's analysis was "so far beyond the pale, no serious lawyer could advance it." Latham's refusal to opine, he inferred, could not reflect the firm's real view of the Contribution.

The Vice Chancellor disagreed. Four distinguished law firms and two academic experts had analyzed the disguised-sale issue. Yet they had reached five different conclusions. Plainly, this was a matter about which tax lawyers could honestly disagree.

In the end, all Williams could point to was the fact that ETE *really* wanted to get out of the deal—and the fact that Latham, like any law firm, is paid to help its clients achieve their business goals. The court nodded to these concerns but ultimately concluded that Latham had changed its mind in good faith.

ETE was free to walk away, which it did.

Reconstructing the Deal

Like many other observers, the Court of Chancery remarked on the "unusual, perhaps unique" structure of the transaction. It is worth considering why the deal may have been structured the way it was. Let us begin with the Merger.

A cross-species merger of Williams directly into ETE would have triggered corporate tax on Williams' appreciated assets. That is as bad as it gets. A merger of Williams into the newly organized ET Corp, in contrast, would have qualified as a reorganization and avoided corporate-level tax.

That clearly made the case for merging Williams into ET Corp instead of ETE. Nevertheless, it did not explain the parties' need for a merger in the first place. According to the court, the point was to accommodate the Williams shareholders' desire to hold stock of a publicly traded corporation, rather than units of a publicly traded U.S. partnership.

That makes sense, at least as far as non-U.S. and tax-exempt investors are concerned. Williams would merge into ET Corp, which would then transfer the Williams assets to ETE in exchange for partnership units. ET Corp would remain as a "blocker" to insulate Williams' former shareholders from contact with ETE's U.S. trade or business.

Even so, this still does not explain why Williams needed to merge into ET Corp. Why didn't Williams skip the Merger and contribute its assets directly to ETE in exchange for units? Williams itself could have served as the publicly traded blocker corporation. Doesn't that tick the requisite boxes?

Getting the Boot

It's possible that merging Williams into ET Corp served some independent business purpose. If so, the court did not say what it was.

However, it is not hard to see a *tax* motivation. Merging Williams into ET Corp would have qualified as a corporate reorganization. That means that the merger consideration could have included $6 billion in cash boot *without* triggering gain on the transfer of Williams' assets.

The tax results if Williams had simply contributed its business to ETE in exchange for units and $6 billion in cash would have been much less favorable. Under Code Sec. 707(a), Williams' transfer of its assets in exchange for ETE units and $6 billion in cash would have been treated as a sale of assets worth $6 billion. The boot would have subjected Williams to corporate-level tax.

Tax Team Opts for Hook Stock

Starting the acquisition with the Merger made sense as a way to funnel $6 billion to the Williams' shareholders without triggering tax on the asset transfer. However, that would have raised another issue. Where would the newly organized ET Corp have gotten the $6 billion?

In a conventional acquisition, ETE would have contributed the $6 billion to its new acquisition subsidiary. Alternatively, ETE could have agreed to pay the Williams shareholders directly at closing. However, that would still have been an indirect contribution to ET Corp.

The problem with having ETE contribute $6 billion to ET Corp would have been the risk that the IRS would combine it with ET Corp's contribution of the Williams assets to ETE. If the two steps had been collapsed, ET Corp would have been seen transferring the Williams assets to ETE in exchange for partnership units and $6 billion in ETE cash. The cash would have raised an enormous red flag under Code Sec. 707(a).

This concern brings us to the second unusual feature of the deal, ETE's purchase of the Hook Stock from ET Corp. One would have to strain to find a business reason for ETE to pay $6 billion to acquire an indirect interest in itself. ETE's Head of Tax certainly did not offer one.

Instead, he testified that ETE's purchase of the Hook Stock was "the tax team's idea" to "avoid a disguised sale." The idea, as noted above, would have been to have ETE pay its $6 billion for a separate asset—the shares. If the Hook Stock had been worth $6 billion, ETE could have argued that none of the $6 billion had really been paid to acquire the Williams assets from ET Corp.

Thus, concern about a disguised sale was not some novel theory developed only after the value of the Hook Stock took a nosedive. It was the reason the Hook Stock was in the deal in the first place.

All that was new in the spring of 2016 was the realization that the tax team's "solution" to the disguised-sale problem had failed to provide for a decline in the value of the Hook Stock. To address that risk, the merger agreement should have provided that the number of shares that ETE would receive for its $6 billion would float up or down as necessary to ensure that ETE got shares worth $6 billion.

ETE's Head of Tax actually testified that this is what he *thought* the deal was until March 2016. It was only when he was reviewing a description of the terms in an SEC filing that he realized that the Hook Stock represented a *fixed* interest in ET Corp.

Did Latham Make the Right Call?

The *Williams* case did not decide whether Latham was right to change its mind, or even whether it was reasonable for it to do so. The only question was Latham's good faith. After hearing the witnesses, the court concluded that Latham had honestly decided that it could no longer render a "should" opinion.

But even if Latham made its call in good faith, was it the *right* call? Latham would have been correct to balk if the Hook Stock had been worth only $2 billion when the deal was signed in September 2015. If ETE had knowingly agreed to pay $6 billion for stock worth only $2 billion, it would have been impossible to argue that ETE was paying the extra $4 billion

to acquire the shares. Under Code Sec. 707(a), ET Corp would have been treated as selling assets worth $4 billion.

In the actual deal, the Hook Stock was worth $6 billion when the papers were signed. If the transaction had closed immediately, Latham would have opined without hesitation that the Contribution "should" qualify under Code Sec. 721(a).

However, public-company deals cannot close immediately. ETE was inevitably exposed to fluctuations in the value of the Hook Stock in the months following signing. Under the merger agreement, the collapse of asset values in the pipeline industry did *not* excuse ETE from its obligation to pay $6 billion for the Hook Stock.

Latham's decision that it could not render a "should" opinion was based on concern about how the IRS would view the transaction if ETE paid $6 billion for shares worth only $2 billion. With an extra $4 billion sloshing around in the deal, the IRS might find it tempting to argue that the excess cash was actually paid for the Williams assets.

But how far would such an argument have gotten, even within the IRS? ETE, after all, had agreed to pay $6 billion for the Hook Stock at a time when that was the reasonably anticipated value of the shares. The $4 billion decline was due to industry-wide economic factors over which the parties had no control. If ETE had ended up paying $4 billion more than the Hook Stock was worth, it would have been because Williams was legally entitled to the benefit of ETE's bad bargain.

It therefore seems unlikely that ETE's overpayment for the shares, *per se*, would have established—or even suggested—that the $4 billion was actually paid for the Williams assets. Latham made its call in good faith. However, one may still wonder whether it overreacted to the decline in the value of the Hook Stock.

Hook Stock: Corporate Loopiness?

Unlike Latham, Morgan Lewis concluded that it would not have been able to opine on the Contribution even if there had been no change in the value of the Hook Stock. Morgan Lewis pointed to the risk that the IRS would "consider the cash component of the overall asset transfer between [ET Corp] and [ETE] as a hidden asset purchase." The "cash component" would mean the *full $6 billion*, not just the excess over the value of the Hook Stock at closing.

The court provided few details about the basis for Morgan Lewis's concern. What we are told suggests that Morgan Lewis doubted that the Hook Stock was a sufficiently substantial asset to warrant allocating *any* of ETE's $6 billion payment to the shares. Such doubts would be understandable.

When we say the Hook Stock was worth $6 billion in September 2015, what do we mean? We are implicitly referring to the amount that a person unrelated to ETE would have been willing to pay for the shares—the "third-party value" of the Hook Stock.

However, the fact that the third-party value of the Hook Stock was $6 billion in September 2015 does not mean that it was worth $6 billion *to ETE*. What, after all, would ETE have received for its $6 billion in cash?

The Hook Stock would have represented a 19-percent interest in ET Corp. Following the Contribution, ET Corp would have been a corporate shell containing nothing but partnership units issued by ETE. The Hook Stock would have provided ETE with an indirect ownership interest *in itself*.

Here we are faced with what one commentator, adapting a term from the logician Douglas Hofstadter, has called a "strange loop." [*See* Stephen B. Land, *Strange Loops and Tangled Hierarchies*, 52 Tax L. Rev. 45 (1996).] ETE was contractually obligated to pay $6 billion in cash to obtain what was, at bottom, an interest in ETE.

This is not the occasion to pursue ETE through the looking-glass of self-ownership. However, we can at least observe that the Hook Stock would have been a most unorthodox "asset" in ETE's hands. Most notably, ETE's acquisition of the Hook Stock would have done nothing to increase ETE's value.

Suppose that ET Corp had liquidated after paying the $6 billion to the former Williams shareholders. ETE would have received a distribution consisting of its own partnership units. Those units—like treasury stock of a corporation—would have had no value in ETE's hands.

U.S. tax law wisely ignores treasury stock. Historically, however, it has treated hook stock

as normal stock. In line with this, Latham assumed that there would be no disguised-sale problem as long as the Hook Stock's *third-party* value was $6 billion.

Morgan Lewis, on the other hand, seems to have been worried that the IRS might focus on the value of the Hook Stock *to ETE*. If the Hook Stock was worthless in ETE's hands, *any* amount that ETE paid for it would have been an overpayment, regardless of its third-party value at closing.

ETE would have transferred partnership units and $6 billion to ET Corp in exchange for the Williams assets and a worthless claim against itself. The IRS might logically contend that the *full $6 billion* was actually paid to acquire the Williams assets. This, of course, would have been a taxable sale under Code Sec. 707(a).

From this perspective, Latham made the right call for the wrong reason. The problem was not that the third-party value of the shares had declined, but that the Hook Stock would not have had any value to ETE in the first place. A "should" opinion would have been unwarranted even if the transaction had closed on September 28, 2015.

Limits of Consensus

There is an inherent fuzziness in the concept of "should." In fact, it is surprising that it causes as few tax-opinion problems as it does. But a shared professional culture is a powerful thing. It can produce practical consensus even when its participants lack precise definitions of the concepts they employ.

The *Williams* case, however, suggests that the professional consensus among tax practitioners has its limits. Next time it should come with a warning label: "Caution—May dissolve if immersed in a $6 billion pool of cash."

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