MLP Agreement Lessons From Delaware High Court

Law360
March 21, 2017, *Matthew J. O'Toole, Christopher N. Kelly and Eric R. Glickman*

Introduction

In three decisions over the last year, the Delaware Supreme Court has considered whether a general partner's utilization of conflict resolution provisions in the partnership agreement of a master limited partnership ("MLP") immunized a conflict-of-interest transaction from judicial review.[i] In two of those decisions, *The Haynes Family Trust v. Kinder Morgan G.P., Inc.*[ii] and *Employees Retirement System of the City of St. Louis v. TC Pipelines GP, Inc.*,[iii] the Court answered that question in the affirmative, confirming that Delaware law gives maximum effect to the principle of freedom of contract and that the State's courts will enforce the express terms of alternative entity agreements. In the third decision, *Dieckman v. Regency GP LP*,[iv] however, the Court found, based on the unique facts alleged by the plaintiff, that there was sufficient doubt whether the general partner of the MLP had complied with implicit requirements naturally inferred from the express terms of the partnership agreement's conflict resolution provisions.[v]

Kinder Morgan

In *The Haynes Family Trust v. Kinder Morgan G.P., Inc.*,[vi] the Delaware Supreme Court, sitting *en banc*, affirmed the Court of Chancery's dismissal of a purported class action brought by former unitholders of Kinder Morgan Energy Partners, L.P. ("KM Partnership"). Those unitholders challenged a going-private transaction whereby KM Partnership was merged with a wholly owned subsidiary of its general partner, Kinder Morgan G.P., Inc. ("KM General Partner"), and, as a result, became an indirect wholly owned subsidiary of Kinder Morgan, Inc. ("KM Parent").[vii] Contemporaneously with that merger, Kinder Morgan Management, LLC ("KM Management"), to whom KM General Partner had delegated its authority to manage KM Partnership, was merged with a different wholly owned subsidiary of KM General Partner.[viii] The equity holders of KM Partnership and KM Management received equal consideration in the transactions, notwithstanding the alleged facts that KM Management shares historically traded at a discount to KM Partnership units and the KM Management transaction was tax-free for its stockholders.[ix]

In the Court of Chancery, the plaintiffs primarily argued that KM General Partner breached its express and implied contractual obligations under KM Partnership's limited partnership agreement because the members of the conflicts committee (the "KM Committee") employed by KM General Partner to obtain "Special Approval" of the transaction under the conflict resolution provisions in the partnership agreement allegedly were conflicted and ineffective in their negotiations with KM Parent, and because they did not act in good faith in approving the merger.[x] On defense motion, the court dismissed the plaintiffs' complaint for failure to state a claim.[xi]

The Court of Chancery first found that the plaintiffs' allegations were insufficient to state a claim for violation of the Special Approval provision, which the court interpreted as permissive in any event.[xii] The court noted that the plaintiffs did not dispute that the members of the KM Committee met the "minimal requirements" to be eligible to serve on the KM Committee, even though they were directors of, and simultaneously served on the transaction committee of, KM Management, an affiliate of KM General Partner.[xiii] The court rejected the plaintiffs' argument that the KM Committee did not believe the merger was "fair and reasonable" to, and in (or not inconsistent with) the best interests of, KM Partnership, observing that the allegations in the complaint "actually support[ed] [the inference] that the [KM] Committee acted reasonably and in the best interests of the [KM] Partnership by agreeing to the [merger] and solving the [KM] Partnership's [financial issues]."[xiv] The court also rejected the plaintiffs' contention that the KM Committee voluntarily assumed a duty to act in the best interests of the unitholders simply because it opined as to its view of the fairness of the transaction to the unaffiliated unitholders in the disclosure statement.[xv]

The Court of Chancery next concluded that the complaint failed to adequately plead a claim for breach of the implied covenant of good faith and fair dealing.[xvi] The court explained that the KM Committee members did not face a conflict by also serving on the KM Management transaction committee because the interests of KM Partnership and KM Management were aligned in bargaining for the most consideration possible from KM Parent,[xvii] and, "in the hypothetical original bargaining position, the prospect of having three disinterested, independent decision-makers allocate consideration between two competing constituencies would not be regarded as objectionable."[xviii]

On appeal, the Supreme Court affirmed the Court of Chancery's dismissal of the case.[xix] The Court agreed with the trial court "that there was no room for a substantive

judicial review of the fairness of the transaction, because the general partner had complied with its contractual duties in the approval process of the merger and that compliance conclusively established the fairness of the transaction[.]"[xx] The Court likewise found that the trial court "properly held that the unitholders could not seek to hold the general partner or the other defendants responsible for duties inconsistent with the agreement, simply because the approval committee opined as to its view of the fairness of the transaction to the unitholders unaffiliated with the general partner."[xxi]

TC Pipelines

In *Employees Retirement System of the City of St. Louis v. TC Pipelines GP, Inc.*,[xxii] the *en banc* Delaware Supreme Court affirmed the Court of Chancery's dismissal of a purported class and derivative action challenging an MLP dropdown transaction. The Supreme Court agreed with the trial court that the general partner's compliance with the "Special Approval" provision in the partnership agreement precluded judicial scrutiny of the transaction.[xxiii]

The suit was brought by a unitholder in TC Pipelines, LP ("TCP") and it challenged a transaction in which TransCanada Corporation, the parent of TCP's general partner, TC Pipelines GP, Inc. ("TCP-GP"), sold a pipeline asset to TCP (the "Dropdown").[xxiv] The Dropdown was approved by TCP-GP's conflicts committee.[xxv]

In the Court of Chancery, the plaintiff asserted claims for breach of TCP's limited partnership agreement and breach of the implied covenant of good faith and fair dealing, contending that the conflicts committee did not act in good faith and that the Dropdown was not fair and reasonable to TCP.[xxvi] In moving to dismiss, the defendants argued that the transaction was conclusively deemed fair and reasonable because it was approved pursuant to a "safe harbor," namely, the "Special Approval" provided by the conflicts committee.[xxvii] The court agreed with the defendants and dismissed the action.[xxviii]

The Court of Chancery rejected the plaintiff's argument that the contractual safe harbor was not satisfied because the TCP partnership agreement explicitly required the conflicts committee to act in good faith when providing Special Approval.[xxix] No such express requirement existed, however, as the court concluded that Special Approval required only that a conflicted transaction be approved by a majority of the members of the conflicts committee, and that such members be independent of TCP-GP (and its affiliates) and informed of material facts—requirements which indisputably were

satisfied.[xxx] Consequently, the court held that Special Approval rendered the Dropdown conclusively fair and reasonable to TCP, leaving "no room for judicial scrutiny" of the substance of the transaction.[xxxi] The plaintiff's claims for breach of the express terms of the partnership agreement therefore were dismissed.[xxxii]

The trial court also dismissed the claims for breach of the implied covenant of good faith and fair dealing, rejecting the argument that, to the extent the express terms of the partnership agreement did not impose a duty of good faith on the conflicts committee, such a duty must be inferred.[xxxiii] The court found that the safe harbor provision "explicitly supplie[d] the standard the Conflicts Committee must follow," and explained that the plaintiff's "primary complaint" was not that the committee failed to comply with the safe harbor's guiding standard, but that it "approved a transaction that the [p]laintiff believes [was] unfair to the unitholders from their point of view," which did not implicate the implied covenant.[xxxiv]

On appeal, the Supreme Court affirmed.[xxxv] In doing so, the Court stated, in pertinent part, as follows:

[T]he appellant cannot escape the conclusive effect given to Conflicts Committee approval solely by attacking the fairness of the underlying transaction. If that was the case, the safe harbor would be virtually no safe harbor at all as every case would proceed to discovery so long as a plaintiff could plead facts suggesting a rational person could deem the transaction unfair.[xxxvi]

The Court also observed that, for a plaintiff to invoke the implied covenant of good faith and fair dealing in the MLP special approval context, she "must plead some specific facts suggesting that the Conflicts Committee process was tainted in some specific way by unanticipated behavior, such as the example of bribery . . . , or other factors bearing on whether the Conflicts Committee process fulfilled its evident contractual purpose."[xxxvii]

Regency

In *Dieckman v. Regency GP LP*,[xxxviii] the Delaware Supreme Court reversed the Court of Chancery's dismissal of a purported class action brought by a former unitholder of Regency Energy Partners LP ("Regency") challenging the acquisition of Regency by an entity affiliated with Regency's general partner.[xxxix] The Supreme Court found that the plaintiff

had adequately pled claims for breach of Regency's limited partnership agreement and breach of the implied covenant of good faith and fair dealing.[xl]

In the Court of Chancery, the defendants moved to dismiss, invoking the permissive contractual safe harbors of "Special Approval" and "Unaffiliated Unitholder Approval."[xli] In granting that motion, the trial court reached only the Unaffiliated Unitholder Approval safe harbor, finding that it had been satisfied.[xlii] The court explained that all fiduciary duties had been displaced by Regency's partnership agreement, and that the partnership agreement's "single disclosure requirement"—a mandate that a copy or summary of the merger agreement be provided to unitholders before they voted on a transaction—had been fulfilled.[xliii] According to the court, because Unaffiliated Unitholder Approval had been obtained, "the Merger [was] deemed approved by all the limited partners, including plaintiff, and [was] immune to challenge for a contractual breach."[xliv] In light of "the express waiver of fiduciary duties and the clearly defined disclosure requirement," the court further found that the implied covenant of good faith and fair dealing "ha[d] no work to do" and could not supplement the partnership agreement with additional disclosure obligations.[xlv]

The Supreme Court, sitting *en banc*, reversed, concluding that the plaintiff adequately pled claims for breaches of Regency's partnership agreement and the implied covenant.[xlvi] According to the Court, the complaint alleged sufficient facts suggesting that Regency's general partner made false and misleading statements in the proxy statement to obtain Unaffiliated Unitholder Approval and used a conflicted Conflicts Committee to obtain Special Approval; therefore, it was reasonably conceivable that those safe harbor provisions were not available to the general partner and did not shield the merger from judicial review.[xlvii]

The Supreme Court held that "implied in the language of the LP Agreement's conflict resolution provision is a requirement that the General Partner not act to undermine the protections afforded unitholders in the safe harbor process."[xlviii] The Court explained that drafters of partnership agreements governing MLPs "do not include obvious and provocative conditions in an agreement like 'the General Partner will not mislead unitholders when seeking Unaffiliated Unitholder Approval' or 'the General Partner will not subvert the Special Approval process by appointing conflicted members to the Conflicts Committee.'"[xlix] Those terms "are easily implied" because they "are so obvious to the participants that they never think, or see no need, to address them."[l]

The Special Approval provision called for the approval of the transaction by a majority of the members of a conflicts committee of the board of the Regency general partner; that committee was to consist entirely of two or more directors who were neither security holders, officers, or employees of Regency's general partner nor officers, directors, or employees of any affiliate of the general partner.[li] The Court interpreted this provision as implying a condition that the conflicts committee "be genuinely comprised of qualified members and that deceptive conduct not be used to create the false appearance of" independence.[lii] In the Court's view, the plaintiff adequately alleged facts calling into question the independence of the conflicts committee.[liii] The Court observed that the chair of the two-person committee purportedly "started reviewing the transaction while *still* a member of an Affiliate board" and allegedly resigned from the affiliate board just a few days before becoming a member of the conflicts committee.[liv] The Court similarly noted that both members of the committee allegedly "joined an Affiliate's board the day the transaction closed," and purportedly "failed to satisfy the audit committee independence rules of the New York Stock Exchange, as required by the LP Agreement."[lv]

As for the Unaffiliated Unitholder Approval safe harbor, the Court explained that Regency's general partner "did not have the full range of disclosure obligations that a corporate fiduciary would have had."[lvi] Nevertheless, the Court found that, by issuing a proxy statement to induce unaffiliated unitholders to vote in favor of the merger and thereby avail itself of the safe harbor, Regency's general partner had the implied obligation not to mislead unitholders.[lvii] Because the proxy statement did not inform unitholders about the nearly contemporaneous service of the conflicts committee members on the board of an affiliate, the Court held that it was reasonably conceivable that Regency's general partner had materially misled unaffiliated unitholders in breach of the limited partnership agreement and implied covenant.[lviii]

Conclusion

The *Kinder Morgan*, *TC Pipelines*, and *Regency* cases illustrate that the Delaware Revised Uniform Limited Partnership Act (the "Act") provides an MLP sponsor and its counsel substantial flexibility to privately order the affairs of an MLP. This latitude includes the ability to eliminate a general partner's fiduciary duties to the entity and its investors by appropriate provisions in the partnership agreement. The contractual freedom afforded by the Act and the deference paid by the State's courts to the express terms of the partnership

agreement are subject, however, to the limited application of the implied covenant of good faith and fair dealing. The implied covenant cannot be eliminated.

Accordingly, a general partner's satisfaction of a safe harbor provision in an MLP's partnership agreement generally will immunize a conflicted transaction from judicial review. This principle holds even if the applicable safe harbor requirements are minimal. For example, in *Kinder Morgan*, the Special Approval provision did not prohibit conflicts committee members from serving also as directors of an affiliate of the MLP's general partner—the provision was satisfied.

Still, there may be room for the operation of the implied covenant of good faith and fair dealing. As seen in *Regency*, the displacement of the fiduciary duty of disclosure by a minimal disclosure obligation may not protect the general partner where it is alleged to have voluntarily issued false or misleading disclosures in order to obtain Unaffiliated Unitholder Approval. That is, if a general partner chooses to go beyond express contractual disclosure requirements in order to induce unitholder action, the general partner thereby may undertake a duty to speak accurately and completely.

Additionally, where a general partner's unanticipated misconduct undermines the purpose of a conflict resolution provision, literal compliance with the express terms of the provision may not afford the expected safe harbor. Thus, in *Regency*, the alleged behavior of the general partner—subverting the conflicts committee independence requirement for Special Approval—was found to implicate the implied covenant.

In sum, an MLP sponsor and its counsel should take care when structuring the entity to replace default fiduciary duties with clear and unambiguous contractual terms. Moreover, in planning and executing a conflict transaction such as a dropdown or merger with an affiliate, it is important to follow the conflict resolution procedures set forth in the partnership agreement, in *both* form and substance. This is the surest path to immunizing the transaction from judicial review.

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[i] *See Dieckman v. Regency GP LP*, 2017 WL 243361 (Del. Jan. 20, 2017) ("*Regency II*"); *Emps. Ret. Sys. of the City of St. Louis v. TC Pipelines GP, Inc.*, 2016 WL 7338592 (Del. Dec. 19, 2016) ("*TC Pipelines II*"); *The Haynes Family Trust v. Kinder Morgan G.P., Inc.*, 2016 WL 912184, 135 A.3d 76 (Del. 2016) (Table) ("*Kinder Morgan II*").

[ii] 2016 WL 912184, 135 A.3d 76 (Del. 2016) (Table).

[iii] 2016 WL 7338592 (Del. Dec. 19, 2016).

[iv] 2017 WL 243361 (Del. Jan. 20, 2017).

[v] *Id.* at *7-8.

[vi] 2016 WL 912184, 135 A.3d 76 (Del. 2016) (Table).

[vii] 2016 WL 912184, at *1-2; *In re Kinder Morgan, Inc. Corporate Reorg. Litig.*, 2015 WL 4975270, at *1, *12 (Del. Ch. Aug. 20, 2015) ("*Kinder Morgan I*").

[viii] *Kinder Morgan I*, 2015 WL 4975270, at *1, *3.

[ix] *Id.* at *3.

[x] *Id.* at *1-5.

[xi] *Id.* at *12.

[xii] *Id.* at *6-7.

[xiii] *Id.* at *7.

[xiv] *Id.* at *8.

[xv] *Id.* at *8-9.

[xvi] *Id.* at *9-11.

[xvii] *Id.* at *10.

[xviii] *Id.* at *11.

[xix] *Kinder Morgan II*, 2016 WL 912184, at *1-2.

[xx] *Id.* at *1.

[xxi] *Id.* at *2.

[xxii] 2016 WL 7338592 (Del. Dec. 19, 2016).

[xxiii] *Id.* at *1-3.

[xxiv] *Emps. Ret. Sys. of the City of St. Louis v. TC Pipelines GP, Inc.*, 2016 WL 2859790, at *1 (Del. Ch. May 11, 2016) ("*TC Pipelines I*").

[xxv] *Id.* at *2.

[xxvi] *Id.* at *3.

[xxvii] *Id.*

[xxviii] *Id.* at *8.

[xxix] *Id.* at *3.

[xxx] *Id.* at *4-6.

[xxxi] *Id.* at *4-6.

[xxxii] *Id.* at *5-6.

[xxxiii] *Id.* at *6-7.

[xxxiv] *Id.* at *6-7.

[xxxv] *TC Pipelines II*, 2016 WL 7338592, at *3.

[xxxvi] *Id.* at *2.

[xxxvii] *Id.*

[xxxviii] 2017 WL 243361 (Del. Jan. 20, 2017).

[xxxix] Regency GP LP served as Regency's general partner, though most of the decision-making relevant to the case was done by Regency GP LLC, the general partner of Regency GP LP. *Dieckman v. Regency GP LP*, 2016 WL 1223348, at *2 (Del. Ch. March 29, 2016) ("*Regency I*"). For purposes of simplicity, the two entities are referred to collectively as Regency's general partner.

[xl] *Regency II*, 2017 WL 243361, at *2.

[xli] *Regency I*, 2016 WL 1223348, at *1.

[xlii] *Id.* at *6-10.

[xliii] *Id.* at *1, *9-10.

[xliv] *Id.* at *10.

[xlv] *Id.* at *9.

[xlvi] *Regency II*, 2017 WL 243361, at *2.

[xlvii] *Id.*

[xlviii] *Id.* at *7.

[xlix] *Id.*

[l] *Id.* (internal quotation marks and citation omitted).

[li] *Id.* at *4, *8.

[lii] *Id.* at *8.

[liii] *Id.*

[liv] *Id.* at *4, *8.

[lv] *Id.* at *8.

[lvi] *Id.*

[lvii] *Id.*

[lviii] *Id.*

This article was originally published in the March 21, 2017 issue of Law360.