Simpson Thacher

Memorandum

Delaware Chancery Court Finds Breach of Master Limited Partnership Agreement by General Partner for Failure to Evaluate Related Party Transaction Properly

April 28, 2015

Introduction

In an April 20, 2015 memorandum opinion written by Vice Chancellor Laster, the Delaware Court of Chancery, in *In Re El Paso Pipeline Partners, L.P. Derivative Litigation*, found that the general partner of El Paso Pipeline Partners, L.P. (the "partnership"), a publicly traded master limited partnership ("MLP"), breached the partnership's limited partnership agreement by improperly approving a related party transaction and ordered the general partner to pay $171 million in damages.[1] The Court found that the independent directors serving on the conflicts committee of the general partner's board of directors failed to form a subjective belief that a sale of assets from the partnership's parent, El Paso Corporation ("parent"), to the partnership (a transaction commonly known as a "dropdown") was in the best interests of the partnership, as required by the limited partnership agreement. Although the opinion is consistent with previous MLP cases in that the Court evaluated the conflicts committee's actions under the express contractual provisions of the limited partnership agreement rather than traditional fiduciary duties applicable to directors in the corporate context, the opinion demonstrates that even when directors are subject to contractually limited fiduciary standards, their conduct will not be immune from scrutiny in conflict-of-interest transactions.

[1] The partnership's existence as a publicly traded MLP ended in 2014 when the partnership became a wholly owned subsidiary of Kinder Morgan (which also owns the general partner).

Discussion

In 2010, the partnership was a publicly traded MLP. Fifty-two percent of the common units and the entire general partner interest of the partnership were owned by the parent. As owner of the general partner, the parent controlled the partnership and was entitled to appoint all of the directors of the general partner. In the Spring of 2010, the partnership and the parent engaged in a dropdown transaction (the "Spring dropdown") where the parent sold to the partnership a fifty-one percent interest in two subsidiaries that owned a 190-mile natural gas pipeline and a liquefied natural gas terminal. In the Fall of 2010, the parent and the partnership engaged in another dropdown (the "Fall dropdown") where the parent sold to the partnership the remaining forty-nine percent interest in the assets transferred in the Spring dropdown plus a fifteen percent interest in a separate parent subsidiary that owned a 7,600 mile natural gas pipeline.

The limited partnership agreement authorized the general partner to approve interested party transactions such as dropdowns by one of four different paths, one of which was "Special Approval," which required that a conflicts committee consisting of independent board members of the general partner approve a transaction in the good faith belief that the transaction is in the best interests of the partnership. Special Approval was the path taken for both the Spring dropdown and the Fall dropdown.

Delaware courts have previously held that a good faith standard similar to the one in the limited partnership agreement requires only that the conflicts committee have a subjective good faith belief that the proposed transaction is in the best interests of the MLP and does not impose any objective or reasonableness standard with respect to a "belief." To prevail on a claim that the conflicts committee breached its contractual duty of good faith, the plaintiff cannot merely show that a belief was unreasonable or misguided but rather must prove either (1) that the conflicts committee acted in subjective bad faith, meaning that the conflicts committee believed that the dropdowns were not in the best interests of the MLP, or (2) that the conflicts committee consciously disregarded its contractual duty to form a subjective belief that the transaction was in the best interests of the MLP.[2]

The plaintiff filed suits challenging the Spring dropdown and the Fall dropdown, alleging that the general partner breached the limited partnership agreement. The Court granted summary judgment in favor of the defendants with respect to the Spring dropdown in a separate opinion decided on June 12, 2014[3] and partially denied the defendant's motion for summary judgment as to the Fall dropdown in a separate order issued on June 12, 2014.[4]

In a post-trial decision, the Court concluded that the general partner had breached the limited partnership

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[2] *Allen v. Encore Energy Partners, L.P.*, 72 A.3d 93, 104-106 (Del. 2013).

[3] *In Re El Paso Pipeline Partners, L.P. Derivative Litigation*, 2014 WL 2768782 (Del. Ch. 2014).

[4] *In Re El Paso Pipeline Partners, L.P. Derivative Litigation*, 2014 WL 2641304 (Del. Ch. 2014) (Order).

agreement with respect to the Fall dropdown. The Court made a number of findings which led to its conclusion that the conflicts committee failed to form a subjective good faith belief that the Fall dropdown was in the best interests of the partnership. The Court cited communications among the members of the conflicts committee in which they expressed the view that the Fall dropdown would not be in the best interests of the partnership as well as communications discussing their views regarding the values for the Spring dropdown and the Fall dropdown, which were significantly below the amounts eventually paid in both transactions. The Court also concluded that the committee members did not view their job as one of evaluating whether the Fall dropdown was in the best interests of the partnership but rather believed they were merely supposed to determine whether the Fall dropdown would be accretive, which the Court emphasized is a measure of the short term impact of a transaction on the level of distributions to equity holders rather than an indication of the long term value created by a transaction. The Court also criticized the conflicts committee for having fallen into a "comfortable pattern" in approving dropdowns and failing to negotiate seriously with the parent.

Finally, the Court was critical of the analysis undertaken by the committee's financial advisor. In particular, the Court pointed out a number of inconsistencies between the analysis prepared by the financial advisor for the Spring dropdown and the analysis prepared for the Fall dropdown even though the transactions involved, in part, the same assets. The Court criticized both the absence of clearly articulated reasons for the changes in the financial advisor's analyses between the Spring dropdown and the Fall dropdown and the conflicts committee's apparent unawareness of these changes.

Conclusion

While Delaware courts continue to respect the subjective good faith standard that is commonly used for conflict-of-interest transactions for MLPs, the opinion highlights the importance of careful process and documented analysis in all board proceedings. The opinion is a reminder that directors and their advisors should (1) take care to understand the precise nature of their duties, (2) strive to build a consistent record, including by ensuring that board decisions are consistent with privately expressed views, and (3) to the extent inconsistencies exist or analyses change, identify and articulate a clear and contemporaneous explanation for such inconsistencies or changes. The *El Paso* decision reemphasized the point, made in other Delaware opinions, that directors need to be aware of, and understand, material changes to the financial analyses from advisors on which they are relying. Had the conflict committee members been able to demonstrate that they were aware of inconsistencies and changes in analyses and been able to provide the Court with explanations for such inconsistencies and changes, the Court may well have reached a different result.

You can download a copy of the April 20, 2015 opinion by clicking here.

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