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MLPs Take Center Stage in the Delaware Supreme Court

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The Supreme Court of the State of Delaware has recently issued a series of opinions relating to publicly traded master limited partnerships (MLPs) that reaffirm the enforceability of contractual provisions that modify default fiduciary duties and uphold the use of contractual "safe harbors" to cleanse conflicted transactions. In addition, at least one of those decisions reiterates that parties may not contractually eliminate the implied contractual covenant of good faith and fair dealing (the implied covenant) and that claims based on the implied covenant will not be dismissed in circumstances where a complaint sufficiently pleads that a contracting party has engaged in arbitrary and unreasonable conduct resulting in an unfair transaction.

In *Brinckerhoff v. Enbridge Energy Company, Inc.*, 67 A.3d 369 (Del. 2013), the Delaware Supreme Court affirmed the Court of Chancery's decision to dismiss derivative claims brought by a limited partner of Enbridge Energy Partners, L.P. (EEP) challenging the fairness of a joint venture agreement, or JVA, entered into between EEP and Enbridge, Inc., the controlling parent of EEP's general partner. The plaintiff alleged that Enbridge purchased its stake in the joint venture from EEP for $560 million below fair value. The Court of Chancery dismissed the complaint in light of the exculpation provisions contained in the partnership agreement eliminating personal monetary liability of the general partner and its affiliates so long as they acted in good faith. The court first concluded that the general partner was entitled to a conclusive presumption of good faith under the partnership agreement because the general partner approved the JVA only after a special committee of the board received a fairness opinion from its financial adviser. Additionally, the court concluded that the complaint failed to allege facts suggesting that either the directors or Enbridge acted in bad faith. The court focused on the facts that the general partner's board of directors appointed an independent special committee that hired its own financial and legal advisers, negotiated an increase in EEP's equity stake in the JVA, and received and relied upon an opinion from its financial adviser that the JVA terms were "representative of an arm's length transaction. . . ." On remand from the Delaware Supreme Court to consider plaintiff's claims for equitable remedies of reformation and rescission, the Court of Chancery held that plaintiff waived those claims by failing to assert them in response to the motion to dismiss.

On appeal, the Delaware Supreme Court affirmed, based on the complaint's failure to adequately allege that the defendants acted in bad faith. Quoting the standard for bad faith set forth in *Parnes v. Bally Entertainment Corporation*, 722 A.2d 1243 (Del. 1999), the Supreme Court noted that, in order for the plaintiff to succeed, the decision to enter into the JVA must have been "'so far beyond the bounds of reasonable judgment that it seems essentially inexplicable on any ground other than bad faith.'" The Supreme Court also affirmed the Court of Chancery's ruling that the plaintiff waived his reformation and rescission claims and, therefore, did not reach the merits of those claims. Because the Delaware Supreme Court affirmed based on the failure to plead bad faith, it declined to consider the effect ("either to preclude or limit judicial review") of the conclusive presumption of good faith resulting from reliance on the financial adviser's fairness opinion or the implied covenant claims. The Court would take up the former issue in the other MLP opinion it issued on the same day, *Norton v. K-Sea Transportation Partners L.P.*, 67 A.3d 354 (Del. 2013).

In *Norton v. K-Sea*, the Delaware Supreme Court affirmed the Court of Chancery's dismissal of a complaint challenging the acquisition of K-Sea Transportation Partners L.P. (K-Sea) by a third party. Among other allegations, the plaintiffs alleged that the general partner of K-Sea was conflicted in approving the merger because it received $18 million of the $329 million purchase price in consideration for its incentive distribution rights (IDRs). The plaintiffs alleged that the IDRs were actually worth as little as $100,000. The board of the general partner appointed a conflicts committee to evaluate the transaction and provide "special approval" of the conflicted transaction. The conflicts committee hired a financial adviser that opined that the merger consideration was fair to the unaffiliated unitholders, but did not render a separate opinion regarding the fairness of the $18 million payment to K-Sea for the IDRs. The Court of Chancery dismissed the complaint without addressing the "special approval" process, finding instead that the partnership agreement imposed only a "good faith" standard on the defendants – a standard which was deemed satisfied under the partnership agreement because the general partner relied on the fairness opinion received by the conflicts committee.

The Delaware Supreme Court affirmed, finding that the defendants' conduct was subject to the "good faith discretion" standard applicable to mergers under the partnership agreement, and not to the "fair and reasonable" standard contained in the safe harbor provision respecting conflict transactions. The Court then considered whether receipt of the fairness opinion resulted in an outcome determinative conclusive presumption of good faith under the partnership agreement. Plaintiffs did not allege that the analysis underlying the fairness opinion was flawed, but rather that the opinion was defective because it did not address the fairness of the $18 million payment for the IDRs. Relying on the terms of the partnership agreement providing that the general partner had no obligation to consider the relative interests of any party in a conflict transaction or to consider the interests of any person other than K-Sea, the Court held that plaintiffs "had no reasonable contractual expectation that [the general partner] or the Conflict Committee's retained investment banker would specifically consider the IDR Payment's fairness." The Court then concluded that, although the fairness opinion was obtained by the conflicts committee and not by the general partner, it would be unreasonable to infer that the entire board and the general partner did not rely on the fairness opinion. As in *Enbridge*, the Court declined to address any implied covenant claims based upon the plaintiff's abandonment of such claims on appeal. But the issue was teed up for the Court to address two weeks later in *Gerber v. Enterprise Products Holdings, LLC*, 67 A.3d 400 (Del. 2013).

In *Gerber v. Enterprise,* the Delaware Supreme Court affirmed in part and reversed in part the Court of Chancery's decision to dismiss a complaint alleging that former limited partners of Enterprise GP Holdings, L.P. (EPE) did not receive fair value in connection with a series of conflicted, related-party transactions. The challenged transactions included (1) EPE's sale in 2009 of Texas Eastern Products Pipeline Company, LLC (Teppco) to Enterprise Products Partners, L.P. (Enterprise Products), the general partner of which was a wholly-owned subsidiary of EPE, for $100 million (only two years after EPE had purchased Teppco for $1.1 billion) and (2) the subsequent merger in 2010 of EPE into a wholly-owned subsidiary of Enterprise Products, which allegedly was done to eliminate derivative claims related to the prior Teppco transactions. A conflicts committee of the EPE board provided "special approval" of both the 2009 Teppco sale and the 2010 merger, and in both instances received a fairness opinion from its financial adviser. As in *Enbridge* and *K-Sea*, the partnership agreement imposed a good faith standard in place of default fiduciary duties. The Court of Chancery dismissed the plaintiff's claims that defendants breached the contractual good faith standard because both transactions received special approval of the conflicts committee. The court also dismissed the plaintiff's implied covenant claims because the general partner was entitled to a conclusive presumption of good faith under the partnership agreement when it relied on a fairness opinion, and that the conclusive presumption applied to implied covenant claims as well as express contract claims.

On appeal, the Delaware Supreme Court affirmed the dismissal of the claims under the partnership agreement's good faith standard in light of the conflict committee's special approval and the receipt of the fairness opinions in each transaction. The Court reversed, however, the dismissal of the implied covenant claims, holding that the conclusive presumption of good faith in the partnership agreement did not bar the plaintiff's claim for breach of the implied covenant. The Court reasoned that the contractual good faith standard was distinct from the implied covenant of good faith and fair dealing, and that the conclusive presumption provision applied only to the contractual good faith standard. In addition, the Court concluded that the conclusive presumption provisions could not eliminate the implied covenant because the Delaware limited partnership statute expressly provides that a partnership agreement may not do so. Looking then to the allegations in the complaint, the Court determined that the general partner's decision to rely on the safe harbors in the partnership agreement was subject to the implied covenant, and that the plaintiff adequately pleeaded breaches of the implied covenant in connection with both transactions. The Supreme Court found the complaint alleged that the financial adviser's opinion respecting the sale of Teppco was flawed because it evaluated the sale of Teppco together with another transaction, rather than just focusing on the Teppco sale. The Court reasoned that, at the time of contracting, the plaintiff "could hardly have anticipated" that the general partner would attempt to satisfy its contractual obligations by relying on a fairness opinion that did not value the consideration that the unitholders actually received. The Court further held that the plaintiff sufficiently pleaded that the general partner "engaged in a manifestly unfair transaction, and then relied on an unresponsive fairness opinion, to ensure that its contractual fiduciary duty would be conclusively presumed to have been discharged. That is the type of arbitrary, unreasonable conduct that the implied covenant prohibits." The "special approval" process with respect to the Teppco sale was similarly subject to the implied covenant which the general partner allegedly breached, given that although the conflicts committee "had no contractual duty to obtain a fairness opinion, the parties would not have agreed that the [conflicts committee] could obtain and rely on a fairness opinion so flawed."

Similarly, regarding the 2010 merger, the Delaware Supreme Court found the complaint alleged that a principal purpose of the merger was to eliminate derivative claims related to the Teppco transactions, and that neither the general partner nor the financial adviser valued those derivative claims in fixing the consideration or opining on the fairness of the merger. The Supreme Court concluded that the parties would have agreed, at the time of contracting, that any fairness opinion contemplated by the conclusive presumption provision "would address the value of derivative claims where (as here) terminating those claims was a *principal purpose* of the merger." (Emphasis in original.) Moreover, notwithstanding the special approval process, the Supreme Court concluded that the "unitholders had a reasonable expectation that if the general partner chose to terminate their investment by way of a merger primarily intended to eliminate valuable assets of the limited partnership (here the [derivative claims]), the LP unitholders would be compensated for the value of those eliminated claims."

In *Allen v. Encore Energy Partners, L.P.*, __ A.3d __, 2013 WL 3803977 (Del. July 22, 2013), the Delaware Supreme Court further considered a contractual good faith standard in a limited partnership agreement. There, it affirmed the dismissal of a class action complaint challenging the merger of a limited partnership, Encore Energy Partners LP (Encore), with the controller of its general partner, Vanguard Natural Resources, LLC (Vanguard). Vanguard acquired Encore's general partner (Encore GP) and 46 percent of Encore's common units from a third party in late 2010, which caused analysts to speculate that Vanguard intended to acquire the remaining units of Encore. Plaintiffs alleged that Encore GP made a number of inaccurate negative disclosures regarding Vanguard after the acquisition designed to depress Encore's value per unit prior to making its merger proposal. In March 2011, when Encore's unit price closed near a two-week low relative to Vanguard's unit price, Vanguard made its initial merger proposal, which proposed to convert each Encore common unit into 0.72 Vanguard common units (reflecting a 0.2 percent premium to Encore's preannouncement closing price). Encore GP delegated authority to a conflicts committee to evaluate and negotiate the terms of the proposed merger. The committee responded by proposing an exchange ratio that was 4.17 percent higher than Vanguard's initial offer, but because Vanguard's units had experienced a company-specific price drop in the interim, the counterproposal represented a 9.1 percent discount to Vanguard's opening offer. Vanguard ultimately agreed to the counteroffer. The financial adviser to the conflicts committee rendered a fairness opinion stating that the terms of the merger were financially fair, but the valuation metrics indicated that the consideration fell below the midpoint on the average valuation range reflected in the fairness opinion. The conflicts committee unanimously approved the merger and recommended it to the Encore board, which in turn approved the merger and submitted it to Encore's unitholders. A majority of Encore's unitholders approved the merger.

On appeal, the Court reviewed the contractual standards that applied to defendants' alleged conduct and determined that Encore's limited partnership agreement (or LPA) eliminated common law fiduciary duties and created a contractual duty which required Encore GP to act in good faith when taking action, including consenting to any merger of Encore with another entity. The LPA defined "good faith" as a "belie[f] that the determination or other action is in the best interests of [Encore]" and included a safe harbor provision similar to the provision in *K-Sea* pursuant to which the conflicts committee could provide "special approval" of a transaction, which would deem a transaction approved and satisfy all of Encore GP's duties. The Court distinguished the provision in the Encore LPA from the provision in *K-Sea*, which required a "reasonable belief," and found that an act is deemed to be taken in good faith if the actor subjectively believes that it is in the best interests of Encore.

However, the Supreme Court rejected the Court of Chancery's determination that to show the lack of a subjective good faith belief the plaintiff needs to assert a claim of subjective bad faith. Instead, the Court held that in addition to subjective bad faith, a party could plead a breach of a subjective good faith standard under a conscious disregard theory and show that there was a conscious disregard for the contractual duty to form a subjective belief (a standard the Court characterized as requiring "an extraordinary set of facts. . . ."). In addition, the Court held that the objective reasonableness of a party's actions is relevant to whether they satisfied the subjective standard and concluded that some actions could be so egregiously unreasonable as to be inexplicable on any grounds other than subjective bad faith. The Court also noted that it may also be reasonable to infer subjective bad faith in less egregious transactions when a plaintiff alleges objective facts indicating that a transaction is not in the best interests of the partnership and the directors knew of those facts. Accordingly, the Court explained, objective factors may inform the analysis of a defendant's subjective belief to the extent they bear on the credibility when asserting that belief. Nevertheless, the Court cautioned against utilizing an objective, reasonable person standard in evaluating a subjective good faith requirement and held that, without more, allegations of poor negotiating, accepting a transaction at the low end of a range of fair values, or poor transaction planning, do not support an inference of subjective bad faith or that committee members did not subjectively believe a merger was in the partnership's best interest.

Key Takeaways

Contract Controls over Fiduciary Duties – But Not the Implied Covenant

These four opinions uphold the validity of contractual modification of fiduciary duties and personal liability, and accordingly provide a level of comfort to MLP participants that the partnership agreement will be enforced as written. This approach gives effect to the clear statutory directive regarding the enforceability of partnership agreements and the ability to "limit" and "eliminate" fiduciary duties and liabilities. As the Court pointed out in *Encore*, to the extent that investors desire the full protection of default fiduciary duties, they should invest in Delaware corporations. 2013 WL 3803977, at *10. The Delaware Supreme Court also appears to be on solid ground in concluding that the statute, by its express terms, does not permit governing agreements to eliminate the implied covenant and that the typical "conclusive presumption of good faith" provision is directed at (and could only apply to) the express contractual good faith standard, not the implied covenant. But the fact that the statute does not permit an agreement to expressly eliminate the implied covenant should not be understood to change the nature of the implied covenant – it should still have very limited application as a gap filler that is subject in all events to the express terms of the contract. In that regard, the decision in *Gerber* is somewhat unsettling to practitioners because it suggests that a Delaware court may use the implied covenant as a means to import a contract-based duty (and to "do equity") when traditional fiduciary duties have otherwise been effectively eliminated or replaced by contractual standards.

Do Alternative Entities Still Provide More Protection than Corporations?

Practitioners have found it difficult to square this well-settled view of the implied covenant with the willingness of the Court in *Gerber* to find questionable gaps in very complex and detailed provisions designed to provide a road map for permissible conflict transactions. Indeed, the safe harbors in MLP agreements are generally designed to encourage and reward good behavior – by putting the decision in the hand of independent directors and encouraging reliance on expert advice. This is not unlike the protection from liability provided in the corporate context under Sections 141(e) and 144 of the Delaware General Corporation Law, which similarly encourages reliance on experts and independent decision makers in conflict situations. But the *Gerber* ruling effectively penalized the general partner's decision to turn over resolution of the conflict to an independent committee advised by independent bankers. After *Gerber*, not only may general partners be inclined to think twice before referring matters to an independent committee, but drafters of MLP agreements and other partnership and LLC agreements may look to other contractual methods that are less protective of the unaffiliated investors but more likely to avoid scrutiny under the implied covenant.

One way to view the safe harbors contained in MLP agreements is as an attempt to achieve the functional equivalent of the business judgment rule for conflict transactions. In the corporate world, the business judgment rule standard will typically lead to prompt dismissal of a shareholder's complaint, and alternative entity statutes clearly permit agreements to achieve this same result in conflict situations. But unlike corporations, alternative entities are exposed to the added burden of the implied covenant, and under *Gerber*, an implied covenant claim may only require allegations of a financially bad deal and a less than perfect fairness opinion in order to survive a motion to dismiss. The *Gerber* ruling could have the unintended effect of encouraging deal planners to use corporations when alternative entities would otherwise be more appropriate.

Secondary Liability Still Up in the Air

The Supreme Court in *Gerber* remanded to the Court of Chancery the question of the validity of "secondary liability" claims of aiding and abetting of a breach of the implied covenant (as well as tortious interference) and whether such claims have been adequately alleged. The Court confirmed prior case law holding that the implied covenant only applies to defendants who are parties to the contract, in this case, the general partner. The other defendants, including the individual directors and the controlling parent, could only be liable if subject to secondary liability claims, which would be contingent on the success (or failure) of the implied covenant claims against the general partner. The Supreme Court's remand of this issue is particularly troubling, given that MLP general partners are typically judgment-proof shell entities and the directors and controlling parents are the principal actors on behalf of the MLP. While Delaware does not recognize the claim of aiding and abetting of breach of contract, the Court of Chancery has recognized aiding and abetting a breach of contractual fiduciary duty.

Exculpation of MLP Directors Called Into Question

Under *Gerber*, the general partner entity of MLPs (and arguably the individual managers of MLPs formed as LLCs) are subject to monetary damages claims for breach of the implied covenant (and the directors and controllers of these entities may also be subject to money damages for aiding and abetting or tortious interference). Importantly, the Delaware limited partnership and LLC statutes do not allow contractual limitation or elimination of liability for a bad faith violation of the implied covenant. The meaning of "bad faith violation" has not been addressed by the courts, and until it is, there may be some question whether typical contractual exculpation protection will apply (or can apply) to implied covenant claims or secondary liability claims related to a breach of the implied covenant.

The Return of Relative Fairness Opinions?

The Court in *K-Sea* ruled that satisfaction of the contractual standards did not require the banker to provide a "relative fairness" opinion (or an opinion that the consideration received by the limited partners was fair when compared to the consideration received by the general partner). The Court specifically relied on provisions in the partnership agreement that made it clear that the general partner had no duty to consider the interests of any person other than the partnership and was not required to consider the relative interests of any party to a conflict. The relevance of this ruling in *K-Sea* has arguable been called into question by *Gerber*, at least to the extent that a fairness opinion will be viewed through the lens of the implied covenant. In *Gerber*, the Court found *K-Sea* to be factually distinguishable, given that in *K-Sea* there was no contractual duty to separately evaluate the IDR payment and that the opinion "indirectly addressed the fairness of the [IDR] payment. . . ." 67 A.3d at 443 n.29. This language from *Gerber* may indicate an expectation that relative fairness must be at least "indirectly" addressed in a fairness opinion. Moreover, the *Gerber* opinion may further require that deal planners anticipate claims under the implied covenant (like those raised in *Gerber*) that the parties would not have agreed (had they thought to negotiate over the issue) that the general partner could rely on fairness opinions that did not address relative fairness or that failed to address fairness to the appropriate persons (such as the unaffiliated limited partners).

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