

Why El Paso Will Have Very Limited Applicability

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For what we believe is the first time, the Delaware Chancery Court has held the general partner of a master limited partnership (MLP) liable to the MLP for the amount by which the court determined that the MLP had overpaid for assets purchased from its parent company in a typical “drop-down” transaction. Vice Chancellor Travis Laster found, in *In re El Paso Pipeline Partners LP Derivative Litigation* (Apr. 20, 2015), that the general partner of the El Paso MLP was liable to the MLP for the \$171 million by which the court determined that the MLP had overpaid for liquefied natural gas (LNG) purchased from the El Paso parent company for \$1.4 billion. The vice chancellor was extremely critical of the conduct of the conflict committee of the general partner’s board, as well as the conduct of the committee’s investment banker. Nonetheless — and notwithstanding commentary on the case suggesting otherwise — in our view, the decision does not indicate that the court will be more likely than in the past to find liability of MLP general partners or their bankers.



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Key Points

Unusual facts. Due to the unusual facts, the decision is an “outlier” in the line of cases in which general partners of MLPs have, as far as we know, never before been held liable in connection with drop-down transactions (whether their process is poor or the assets are overpriced).

Fiduciary duties are inapplicable. By law, an MLP general partner’s fiduciary and common law duties to an MLP can, and typically are, eliminated by contract and replaced with a contractually established low standard of responsibility to the MLP. In connection with drop-downs and other “conflict” transactions, the standard usually is (as it was in El Paso) simply that a committee of the general partner’s independent directors subjectively believes in good faith that the dropdown is in the best interests of the MLP.

Court applied the contractual standard without expansion. The court in El Paso approached the case as a breach of contract case (not a duty of care or loyalty case) and applied the contractual standard as written, without expanding it. The court confirmed that, as previous cases have held, the “subjective belief” component of the standard does not include any requirement of objectivity or reasonableness; and the “good-faith” component requires only that the committee members did not have personal or

other improper motivations, and did not exhibit “conscious disregard” of their known duties, which would constitute “bad faith.”

The court reviewed the committee’s and the banker’s conduct because there was “convincing” evidence that the committee did not actually have the belief about the drop-down that it purported to have. The court explained that its review of the committee’s process was required because there was “convincing” evidence that contradicted the committee members’ testimony as to what they actually subjectively believed about the dropdown. Specifically, there were numerous contemporaneous emails among the committee members, before and during their deliberations, in which the committee members stated their views that the drop-down assets were both undesirable (as they were in the declining LNG market and the MLP already was overexposed in that market) and overpriced.

In determining whether the committee’s subjective belief was what the committee said it was, the court stated: “Trial judges ... are not telepaths [and therefore], where, as here, the Committee members testified that they believed the [dropdown] to be in the best interests of El Paso MLP, the trial judge must make credibility determinations about each defendant’s subjective beliefs ... [and the] objective facts therefore [are] relevant to the extent they permit an inference that the defendants lacked the necessary subjective belief.”

The court determined that the committee did not in fact have the belief that it purported to have that the proposed drop-down was in the best interests of the MLP. Notably, with respect to the testimony, the court found that “the defense witnesses ... had few specific recollections of the [d]ropdown”; “the Committee members and their financial advisor had no explanation for what they did” to evaluate the dropdown; “the few explanations they had were conclusory or contradicted by contemporaneous documents”; and their testimony as to the belief they had about the drop-down being in the best interests of the MLP “seemed over-prepared and artificial.” In the court’s view, the committee exhibited “conscious indifference” to its contractual obligation to determine whether it believed that the drop-down was in the MLP’s best interests. It is important to note the extreme nature of the facts here.

For example, the committee did not know important information about the revenues arising from the assets being acquired, nor even the price that was being paid for the assets. Thus, the committee appeared to lack even the most basic information necessary for any foundation upon which a belief could have been formed. Moreover, every objective fact strongly indicated that the dropdown was not in the MLP’s best interests. Thus, the court concluded from its review of the committee’s and the banker’s evaluations of the drop-down that the emails reflected the committee members’ actual subjective belief about the drop-down.

Background

The El Paso situation was typical in that: the MLP was established and partly owned by a parent company, which also owned and controlled the general partner that managed the MLP; the dropdown involved the MLP acquiring assets from the parent company; and the limited partnership agreement governing the MLP provided that the general partner could approve the drop-down if a committee of independent directors of the general partner (a “conflict committee”) believed that the transaction was in the best interests of the MLP.

The decision has been characterized by some as the latest in a line of cases highlighting the Chancery Court’s recent heightened scrutiny of directors and their financial advisers in connection with conflict-of-interest transactions. Importantly, however, those cases have arisen in the corporate context relating to

fiduciary duties of directors (and bankers' potential liability for aiding and abetting directors' breaches of their fiduciary duties). El Paso in no way expands the concepts of the duty of care or loyalty into the MLP arena when they have been eliminated by contract.

Of course, some level of diligence is required. Clearly, a committee cannot form its subjective belief about a drop-down arbitrarily or whimsically, or without any foundation or understanding. For example, a committee must know what the price being paid is (a fact that the El Paso committee did not know). Further, the court suggested that some amount of negotiation with respect to the dropdown may be required. Certainly, we would counsel a committee to approach evaluation of a drop-down with reasonable diligence. However, El Paso does not suggest a change in the state of judicial review of MLP conflict committees or of the legal standard applicable to an MLP general partner's directors.

The Committee's and Its Banker's Conduct

It is instructive that liability has been rarely found in other drop-down cases — including with respect to those of the nine El Paso MLP drop-downs completed from its initial public offering in 2008 through this transaction in 2010 that were challenged in separate litigations. In those cases, which involved the same committee directors, advised by the same banker and legal counsel, and with the same lead negotiator as in this case, and involved similar claims relating to process and pricing, the court granted summary judgment to the defendants.

What differentiates El Paso from other drop-down cases are the following critical factors: (a) as noted, there were emails among the committee members that contradicted their testimony that they believed that the transaction was in the best interests of the MLP and (b) the committee's and its banker's conduct was so egregious that it led the court to conclude that the committee "never learned enough about [the transaction] to make that determination." The court emphasized that no one factor or set of factors would have led to the court's result, but that "the number of problems reached a tipping point." "At some point, the story is no longer credible," the court commented.

The court's extremely negative view of their conduct is reflected in the unusually harsh language of the opinion, with the court ultimately concluding that: "The Committee members went against their better judgment and did what Parent wanted, assisted by a financial advisor that presented [the] dropdown in the best possible light, regardless of whether the depictions conflicted with the advisor's work on similar transactions or made sense as a matter of valuation theory." We note that, given the distinguished record and long experience of the directors and the banker involved, it is hard to understand how the process went so wrong.

The court found that:

The Committee Lacked Even Basic Knowledge About the Transaction

- The committee did not know even the price being paid for the assets. In fact, the price paid was \$25 million more than the committee thought was being paid (a result the court attributed largely to the committee not having valued the two components of the transaction separately).
- The committee was under the impression that the price paid for the 49 percent interest in the parent company's Elba subsidiary was lower than the price the MLP had paid for a 51 percent

interest in Elba in a drop-down a few months earlier (the “spring drop-down”). In fact, the amount paid for the 49 percent interest was higher than the amount that had been paid in the spring drop-down for the larger interest.

- The committee ignored “lessons learned” from the spring drop-down — including that there was a significant negative market reaction to the (lower) pricing in that transaction, resulting in a 3.6 percent drop in the trading value of the MLP common units on announcement (and leading a committee member to email to the other members: “We will have to negotiate harder next time.”). The court criticized the committee for not trying to negotiate a lower price in this transaction on the basis that the price for the 50 percent interest in Elba in the spring drop-down had been lower than the price here for the 49 percent interest in Elba, even though only a minority interest was being acquired here (as compared to the controlling interest acquired in the spring drop-down) and the market for LNG assets had been in decline since the spring drop-down.
- The committee did not understand the banker’s materials, including which assumptions and inputs had been used in the discounted cash flow analysis, let alone why they had been chosen by the bankers.
- The committee was under the impression that over 90 percent of the revenue derived from service agreements relating to the assets being acquired was guaranteed. In fact, less than 20 percent of those were guaranteed. (The court noted that the committee members were unaware of this fact until the plaintiff mentioned it in this litigation.)
- The committee members had not informed themselves about other relevant and seemingly comparable transactions. As one example, the committee ignored that the El Paso parent company, at the same time it was proposing this drop-down, had rejected a right of first refusal it had to acquire LNG assets at a multiple significantly lower (9.1x EBITDA, or earnings before interest, tax, depreciation and amortization) than the multiple at which it was offering to sell the assets to the MLP in this drop-down (11x EBITDA) — with the parent having characterized the pricing of the assets at that lower implied multiple as “not a pretty picture.”

The Banker Deliberately “Manipulated” its Financial Analyses to Justify the Drop-Down

The court found that the committee’s banker had deliberately “manipulated” its financial analyses to make the transaction look better than it actually was in order to “justify the deal” so that the banker could “collect its [fully contingent] fee.” The banker’s materials differed from the materials used for other recent drop-downs to the MLP of the same assets. Importantly, the court found that the banker’s testimony “offered little” to explain the changes, that many of the changes made did not make financial

sense, and that all of the changes made caused the transaction to look better than it actually was. For example, the court found that:

- The banker “manipulated” its precedent transactions analysis to justify the pricing for the acquisition of a majority interest in Elba by presenting minority acquisitions and majority acquisitions all together without distinction, while in the materials for the spring drop-down and others, the banker had separated minority-acquisition precedents and majority-acquisition precedents, depending on whether the MLP was purchasing a majority or a minority interest.
- The misimpression the committee had about the amount of guaranteed revenue (noted above) arose from the banker’s deletion of material that it had included in the slides used for the spring drop-down and other drop-downs.
- The banker “manipulated” its discounted cash flow methodology by changing, without explanation, the cash flow projection periods, the exit multiples to calculate terminal value, and the upper bound of the discount rate from those used with respect to the spring drop-down and another drop-down a few months afterward.
- The banker used the parent company’s costs of capital in the discounted cash flow analysis rather than the cost of capital for the subsidiary the MLP was acquiring.
- The banker “manipulated” its valuation summary for Elba, and for the other parent subsidiary in which an interest was being acquired, by eliminating valuation methodologies for the business where the summary data would have been inconsistent with the banker’s conclusion.

Other Critical Points to Note

A conflict committee must satisfy the contractual standard. Legal counsel should advise a conflict committee and its banker as to what the applicable standard for approval of a conflict transaction under the MLP’s governing documents is and what is required to satisfy it. The court stated that a standard that requires a belief as to the best interests of the MLP is not satisfied by a belief as to the best interests of the limited partners of the MLP (who are the common unit holders of the MLP). In earlier litigation in this case, the court had stated that the best interests of the MLP can include the interests of all of the MLP’s constituencies, such as its employees, customers, general partner, and incentive distribution rights holders, as well as the limited partners. The court found that the El Paso committee was “fixated myopically” on whether the drop-down would be accretive and therefore permit increased cash distributions to the limited partners. As a result, the court found, the committee considered whether the drop-down was in the best interests of the limited partners and “failed to carry out their known contractual obligation to determine whether the [drop-down] was in the best interests of El Paso MLP.”

A dropdown transaction should be valued based on all relevant factors — accretion alone is probably insufficient. This is an important practical point arising from the decision, as it does not relate to the unusual facts of the case and is applicable to all drop-downs. As discussed above, the El Paso committee had concluded that the dropdown would be immediately accretive and that, therefore, the MLP could increase its cash distributions to the limited partners. We note that an MLP's units trade based largely on yield and expectations as to yield growth, and the primary objective for MLPs is to grow cash distributions over time. While the court acknowledged the importance of accretion, it viewed accretion as "focused on short-term profits" and thus a "separate inquiry" from "valuation." The court stated that valuation of a drop-down should take into consideration the fairness of the price and the potential for adding to the MLP's long-term value — not just the accretion that is in the best interests of the limited partners. We note that a court might not criticize a focus on accretion as the primary relevant factor if a committee has considered the extent to which accretion is the most important factor for the MLP as a whole and has considered the other relevant factors.

Issue of potential aiding and abetting liability for bankers. While not addressed by the court, we note that, although in the context of corporate boards the court has recently expanded the concept of aiding and abetting liability for bankers, it is likely to be significantly more difficult to prevail on a secondary liability theory in the case of MLPs. Under Delaware law, there is no such concept as aiding and abetting liability for a breach of contract — as opposed to a breach of fiduciary duties — which duties, as discussed above, are generally not applicable in the case of MLPs.

Moreover, in drop-down situations, as in El Paso, because the banker advises the committee, and the committee members have no contractual duties as they are not parties to the limited partnership agreement, there are no contractual duties for the committee members to breach, and so there can be no aiding and abetting by the banker of a breach by the committee. Nevertheless, bankers should be aware of the generally greater focus recently on bankers' conduct, particularly since Vice Chancellor Laster's rulings in Rural/Metro (2014) and Del Monte (2012), in which, in the corporate context, the court was highly critical of the bankers' conduct (and, in Rural/Metro, found the banker liable for \$76 million for aiding and abetting the directors' breach of fiduciary duties). While in our view this increased focus in the corporate context will not increase the risk of liability in the partnership context, it can, of course, evoke judicial criticism, with associated reputational risk.

Possible Changes to Current Practice With Respect to MLP Agreements

We do not view El Paso as requiring any changes to usual current practice with respect to the drafting of MLP limited partnership agreements. However, in light of the decision, in drafting an MLP agreement, one could consider changing the typical standard for the conflict committee's approval of a drop-down transaction:

- to provide that the standard is the "best interests of the MLP or of the common unit holders of the MLP" or to define "best interests of the MLP" as being, or as including, "the best interests of the common unit holders"; and/or
- to provide that accretion should be considered the exclusive consideration (or the primary consideration) in determining the best interests of the MLP.

Conclusion

There has been speculation recently that use of the MLP structure may be on the decline. This speculation began after Kinder Morgan's announcement last year of the roll-up of its MLPs. The speculation then increased with the dramatic decline of oil and gas prices and, now, with the El Paso decision. However, we expect that, notwithstanding recent developments, MLPs will continue to be the prototype structure for businesses, such as midstream MLPs, characterized by very long-life assets, limited exposure to new competitive capacity, limited commodity price exposure, essential service protection, and generally definable and manageable risks.

In our view, El Paso will have very limited applicability given the unusual fact situation. In addition, unlike upstream or downstream MLPs, midstream MLPs (which provide an essential service and act essentially as "toll takers") are typically not significantly affected by volatility in oil and gas prices.

Lastly, we are aware of only one other roll-up since the Kinder Morgan roll-up in summer 2014 — the Williams "creeping" roll-up, consisting of the merger in early 2015 of the Williams MLP with another affiliated MLP, followed by the acquisition, announced recently, of the merged MLPs by the Williams parent company. Although we expect that there will be consolidation in the MLP industry, we anticipate that in most cases the partnership form will be retained, and that a roll-up into corporate form will occur only when, for some large MLPs, it provides significant advantages in terms of tax, financing or simplicity of governance.

Although there have been press reports of possible litigation challenging the Williams MLP general partner's approval of the roll-up, we note that the factual situation there is more typical than was the case in El Paso. Our view is that, without highly unusual facts such as those in El Paso (most importantly, contemporaneous statements by conflict committee members that they did not believe the transaction was in the best interests of the MLP), claims challenging approval of MLP roll-ups, drop-downs or other conflict transactions will not result in liability for the MLP general partner or its conflict committee members or bankers.

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