FRIED FRANK
M&A BRIEFING™
FRIED FRANK
friedfrank.com

Importance of Careful Compliance by General Partner with MLP Requirements—ETE

In *Energy Transfer Equity L.P. Unitholder Litigation* (Mar. 1, 2017), the Court of Chancery denied the parties' cross-motions for summary judgment, and ruled that the plaintiffs' challenge to the General Partner's issuance of convertible units to certain (but not all) unitholders, in exchange for their common units (the "Issuance"), required development of a full factual record at trial. The principal issues to be determined, according to the court, were: (i) whether the Conflicts Committee approval of the Issuance was effective (in which case claims of impropriety would be barred) and (ii) whether, in any event, the Issuance was a "distribution" under the partnership agreement (in which case it would have been prohibited, as the agreement provided that all "distributions" must be made pro rata to all the unitholders).

Key Point

- **Limited partnership agreements typically provide broad rights to General Partners that permit the elimination of fiduciary duties to the unitholders and establish "safe harbor" procedures for barring claims against even self-dealing transactions. It is critical, however, that General Partners carefully comply with the agreement provisions—including "staying within the channel" of a safe harbor provision for Conflicts Committee approval of conflicted transactions**. Specifically, *ETE* underscores that, to ensure compliance with a conflicted transaction safe harbor approval process, a Conflicts Committee should be comprised only of members who meet the requirements set forth in the safe harbor provision. Moreover, if non-complying members are inadvertently included, they should be promptly removed or resign as members of the Committee and their removal or resignation should be carefully documented.

Background

After ETE entered into a merger agreement with The Williams Companies, Inc., ETE offered, and then issued, convertible units to certain of its common unitholders, in exchange for those unitholders giving up their common units. The purpose of the Issuance, according to the defendants, was to enable ETE to defer a significant amount of distributions to unitholders in order to facilitate financing of the planned merger. ETE's plan initially had been to do a public offering of common units to all unitholders, but Williams would not provide its consent (which was required under the merger agreement for a registration of securities). The merger agreement ultimately was terminated, leaving the issued convertible units as (in the words of the court) "flotsam" of the merger.

The plaintiffs challenged the General Partner's Conflicts Committee approval of the Issuance based on the composition of the Committee. They also contended that, in any event, the Issuance was a prohibited "distribution" under the MLP agreement as it was not made pro rata to all unitholders.

Copyright © 2017 Fried, Frank, Harris, Shriver & Jacobson LLP
A Delaware Limited Liability Partnership

Although not mentioned by the court, ETE's business prospects were in question and the planned merger was controversial and subject to extensive litigation. The common units included a right to quarterly distributions under certain conditions. The convertible units provided for distributions on a delayed time schedule but with priority over the common units. The convertible units were issued to unitholders representing about 31% of the outstanding common units, with a majority of the convertible units being issued to ETE's Chairman. ETE offered the convertible units to management, certain long-term unitholders, and certain large institutional investors—who, the defendants claimed, could act quickly and could agree to the restrictions on transfers for eight quarters. The plaintiffs claimed, however, that the recipients of the convertible units were "favored insiders."

The defendants argued that the Conflicts Committee approval was effective because, although two directors who did not meet the safe harbor requirements for membership initially were appointed to the committee, the minutes reflected that the Committee was comprised only of the one member who did meet the requirements and that sole member approved the transaction. They also argued that the Issuance was not a prohibited "distribution," but an "exchange for value" in connection with which the Partnership issued securities.

Vice Chancellor Glasscock denied the parties' cross-motions for summary judgment, ruling that it was "appropriate to have a full factual record" developed at trial.

Discussion

Was the Conflicts Committee approval effective? The MLP agreement permitted the General Partner to engage in conflicted transactions (*i.e.*, transactions representing a conflict of interest for the General Partner or its affiliates) if a Conflicts Committee of the General Partner's board approved the transaction. The agreement required that the Conflicts Committee be comprised of one or more directors, none of whom were officers or employees of the General Partner, nor directors, officers or employees of any affiliate of the General Partner. The General Partner initially appointed three directors to comprise the Conflicts Committee—two of whom (Collins and Turner) were directors of affiliates of the General Partner, and one of whom (Williams) met the specified requirements. Approval of a conflicted transaction also was required by the General Partner's Audit Committee, which was comprised of Collins and Williams.

As of the first meeting of the Conflicts Committee, the Committee's records refer "consistently, but not exclusively" to the Committee as being comprised of only one member, Williams. *However, there was no record of any formal removal or resignation of Collins or Turner from the Committee.* There were some inconsistent references to Collins and/or Turner as members of the Committee, and there was an early resolution signed by Collins that appointed the financial advisor to the Committee. The Committee minutes reflected that legal counsel to the Committee had advised that the Committee could engage in joint discussions with the Audit Committee. The Conflicts Committee minutes reflected that, in addition to Williams, Collins also was in attendance at the Conflicts Committee meetings. The Issuance was approved at a joint meeting of the Conflicts and Audit Committees, attended by Williams and Collins; and then, following Collins' departure from the meeting, was approved by Williams as the sole member of the Conflicts Committee.

Based on these alleged facts, the Vice Chancellor wrote that there were "serious questions about the constitution and actions" of the Conflicts Committee and that, based on the preliminary record, he "doubt[ed] that the Defendants [would] be able to rely on the [safe harbor] process here." The Vice Chancellor identified the following as a sufficient issue on which to deny summary judgment: "[D]id the Conflicts Committee consist of one member or three at the time it rendered its finding, and was that finding by a majority of the members of the Committee?" He wrote: "Reaching safe harbors, metaphorical

or actual, typically requires staying within the channel as marked. There remains a gap in the record, warranting further development, to determine whether the strictures of the Special Approval process were met here. That is, who was actually on the Committee, when, and was majority approval received?" The answer, he concluded, "involved factual questions appropriately addressed upon a full record."

Was the Issuance a "distribution" under the partnership agreement? The partnership agreement provided that "distributions" must be made pro rata to all the unitholders. At the same time, the agreement provided that "issuances of securities" could be made to any persons at any time for any consideration. The terms "distribution" and "issuance" were not defined in the agreement. The defendants contended that the Issuance was *not* a "distribution," as it was an exchange for value, which was not in the nature of a dividend or other distribution made *without an exchange of value* from the security holder. The plaintiffs argued that there is no requirement that there be no consideration for a "distribution." Emphasizing that there were no definitions provided in the agreement, and that there were apparently conflicting provisions in the agreement on the issue, the Vice Chancellor ruled that additional facts were necessary for a determination of the parties' intentions with respect to whether the Issuance was a distribution or not. The additional relevant facts, he noted, included "whether the Issuance was a true exchange for value, or simply a way to provide favored unitholders a device to avoid the implication of a Merger which would make cash distributions in the immediate future unlikely."

Practice Points

The decision highlights the importance of careful drafting of, and then careful and timely compliance with, the conflict-cleansing terms of a limited partnership agreement.

- **Importance of careful drafting of, and compliance with, the partnership agreement provisions.** MLP agreements typically provide General Partners with broad authority to effect conflicted transactions so long as the agreement provisions are complied with. Most MLP agreements include a "safe harbor" provision for approval of conflicted transactions by a Conflicts Committee of the General Partner's board. The provision typically requires that the Committee be comprised of one or more directors of the General Partner, all of whom are not officers or employees of the General Partner, nor are directors, officers or employees of any of the General Partner's affiliates. The most common standard for approval of a transaction by a Conflicts Committee is only that a majority of the Committee members *subjectively believe* that the transaction would be in the best interests of the partnership.

- **Removal of Committee members who do not meet the requirements for membership.** If members who do not meet the requirements for Conflicts Committee membership set forth in the partnership agreement are inadvertently appointed, they should be *formally* removed (by resolution and/or resignation) as soon as possible. The removal should be clearly documented.

- **Approval by a Conflicts Committee based on the requisite standard.** Although not an issue in *ETE*, we have noted in other memoranda the importance of the members of a Conflict Committee knowing the standard set forth in the partnership agreement for their approval, ensuring that their determination meets that standard and recording their determination accurately (preferably, tracking the language of the agreement that sets forth the standard). As previous cases have demonstrated, where the prescribed standard is the subjective belief of the members, the Committee's determination can be called into question if there is contemporaneous evidence (such as emails) that suggest that the Committee members did not *actually* believe (or had not done even the minimal work required to have any foundation for the belief) that the transaction was in the best interests of the partnership.

- **Consider the effect of any requirement for approval by additional committees.** If a safe harbor provision requires approval by committees of the General Partner's board *in addition to* a Conflicts Committee, the implications of overlapping membership and joint deliberations of the committees should be carefully considered and records should be maintained to reflect the separate work of each of the committees, to the extent appropriate. Depending on the circumstances, it should be considered whether joint meetings of the committees could taint the process of any one or more of them.

- **Consider who attends committee meetings.** A Conflicts Committee should consider excluding as attendees (although non-members) of its meetings persons who are conflicted with respect to the transaction being considered, as well as persons affiliated with the General Partner who would not qualify for membership on the committee.

- **Consider defining terms in the partnership agreement.** The General Partner should consider the need to precisely define terms in the partnership agreement. This could be particularly important with respect to potential transactions that could be construed as being subject to more than one provision of the agreement (such as, in *ETE*, an issuance of securities that could be interpreted to be either (a) a "distribution" or (b) an "issuance of securities" that involves a "distribution").

- **Importance of an accurate record.** Care should also be taken to ensure that the record with respect to a transaction accurately reflects the business objectives of and actions taken by the relevant parties. The record—including meeting minutes, bankers' presentations, press releases and other documentation—should present accurate and consistent descriptions of the transaction and of actions taken. In *ETE*, for example, the General Partner could have considered amending the partnership agreement to clearly define the terms "distribution" and "issuance" and should have consistently characterized the Issuance as not being a "distribution" (if that characterization were deemed appropriate by counsel).

- **More visible or controversial transactions require even more vigilance with respect to compliance with the partnership agreement.** The need for careful structuring, compliance with the partnership agreement, sensitivity to the record, and avoiding technical "foot-faults" is heightened in the case of transactions, such as *ETE* was, that are highly visible, unusual or controversial, and thus more likely to be challenged (as opposed to, say, a typical drop-down of assets transaction). The *ETE* merger was among the biggest deals ever in the energy industry, with financing difficulties and the deal itself being controversial and arguably favoring insiders.

* * *

Authors:

Abigail Pickering Bomba

Warren S. de Wied

Steven Epstein

Arthur Fleischer, Jr.

David J. Greenwald

Scott B. Luftglass

Philip Richter

Robert C. Schwenkel

Peter L. Simmons

Gail Weinstein

This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its contents. If you have any questions about the contents of this memorandum, please call your regular Fried Frank contact or an attorney listed below:

Contacts:

New York

Jeffrey Bagner	+1.212.859.8136	jeffrey.bagner@friedfrank.com
Abigail Pickering Bomba	+1.212.859.8622	abigail.bomba@friedfrank.com
Andrew J. Colosimo	+1.212.859.8868	andrew.colosimo@friedfrank.com
Warren S. de Wied	+1.212.859.8296	warren.dewied@friedfrank.com
Steven Epstein	+1.212.859.8964	steven.epstein@friedfrank.com
Christopher Ewan	+1.212.859.8875	christopher.ewan@friedfrank.com
Arthur Fleischer, Jr.*	+1.212.859.8120	arthur.fleischer@friedfrank.com
Andrea Gede-Lange	+1.212.859.8862	andrea.gede-lange@friedfrank.com
David J. Greenwald	+1.212.859.8209	david.greenwald@friedfrank.com
Randi Lally	+1.212.859.8570	randi.lally@friedfrank.com
Mark H. Lucas	+1.212.859.8268	mark.lucas@friedfrank.com
Scott B. Luftglass	+1.212.859.8968	scott.luftglass@friedfrank.com
Philip Richter	+1.212.859.8763	philip.richter@friedfrank.com
Steven G. Scheinfeld	+1.212.859.8475	steven.scheinfeld@friedfrank.com
Robert C. Schwenkel	+1.212.859.8167	robert.schwenkel@friedfrank.com
David L. Shaw	+1.212.859.8803	david.shaw@friedfrank.com
Peter L. Simmons	+1.212.859.8455	peter.simmons@friedfrank.com
Matthew V. Soran	+1.212.859.8462	matthew.soran@friedfrank.com
Steven J. Steinman	+1.212.859.8092	steven.steinman@friedfrank.com
Gail Weinstein*	+1.212.859.8031	gail.weinstein@friedfrank.com

Washington, D.C.

Jerald S. Howe, Jr.	+1.202.639.7080	jerry.howe@friedfrank.com
Brian T. Mangino	+1.202.639.7258	brian.mangino@friedfrank.com
Brian Miner	+1.202.639.7340	brian.miner@friedfrank.com

*Senior Counsel

