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Court of Chancery Confirms that Limited Partnership Agreements Can Eliminate All General Partner Fiduciary Duties With Respect to Affiliated Transactions—Dieckman v. Regency

In *Dieckman v. Regency* (March 29, 2016), the Court of Chancery again confirmed that the contractual arrangements set forth in a limited partnership agreement will define the respective rights and obligations of the partners, including with respect to the general partner's fiduciary duties (and related duty of disclosure) in connection with affiliated transactions. The decision continues the Delaware courts' general approach of providing the highest level of protection against limited partners' challenges to transactions between a master limited partnership and its general partner or the general partners' affiliates—so long as:

- the partnership agreement clearly limits or eliminates fiduciary duties and provides a clear process for approval of the transaction (a so-called "safe harbor," which typically involves approval by a conflicts committee of the general partner); *and*
- the process established in the partnership agreement is followed.

Background. In *Dieckman*, the plaintiff challenged the acquisition of Regency Energy Partners LP ("Regency") by an affiliate of the general partner in an $11 billion unit-for-unit merger. The Regency partnership agreement explicitly eliminated all fiduciary and other duties of the general partner with respect to conflicted transactions that were approved by *either* the unaffiliated unitholders *or* a conflicts committee (comprised of two or more directors that were not at the same time serving on the board of the general partner or any of its affiliates). The Regency merger was approved by the unaffiliated holders (by the affirmative vote of 69% of the total unaffiliated units outstanding, which represented 99% of the unaffiliated units present at the meeting), and also was approved by the conflict committee.

The plaintiff contended that the approval of the unitholders was not effective as a safe harbor for the challenged merger transaction because the vote had not been "fully informed," as there was no disclosure relating to a conflict of interest of the conflict committee directors that approved the transaction. The plaintiffs claimed that the approval by the conflict committee also was ineffective due to the alleged conflict of interest of the committee members. The alleged conflict of interest arose based on the two

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conflict committee members having resigned their positions as directors on boards of affiliates of the general partner just for the few days that they served on the conflict committee.

Chancellor Andre G. Bouchard dismissed the plaintiff's claims, holding that neither the unitholder vote process itself, nor the general partner's obligation to "act in good faith," created any additional disclosure requirement beyond that provided for in the partnership agreement (which required only that a copy or summary of the merger agreement be provided to unitholders). Finding the unitholders' approval to have been effective, the court found it unnecessary to address whether the conflict committee approval had also been effective notwithstanding the members' alleged conflict of interest.

Key Points

- **Heightened importance in the current environment of attention to partnership agreement provisions relating to affiliated transactions.** Historically, master limited partnership agreement provisions relating to affiliated transactions were important only infrequently, principally in connection with the occasional dropdown of assets by a general partner to the partnership. However, with current difficult market conditions affecting oil and gas industry MLPs, transactions between MLPs and their affiliates have become more common (and are likely to become increasingly so). Not only dropdowns, but also rollups and insider financings and equity investments, have become more common as general partners seek to provide liquidity, simplify structures, create synergies, and/or improve the financial position of the partnership.

- **Reminder that the court will respect the elimination of general partner fiduciary duties in a public limited partnership agreement.** In *Dieckman*, the Chancellor confirmed (as the court has in past decisions) that a limited partnership can eliminate general partner fiduciary duties. The Chancellor admonished investors to carefully read partnership agreements to understand the limitations that they impose on general partners' obligations and on limited partners' rights.

- **If there is a clear partnership agreement "safe harbor" provision, and the process set forth is followed, a conflicted transaction would be shielded from judicial review.** The decision underscores that, if clearly established and followed, a "safe harbor" process set forth in a partnership agreement (such as approval by a conflicts committee or by the unaffiliated unitholders) will shield a conflicted transaction from judicial review. If a general partner's fiduciary duties are eliminated contractually, the only obligation the general partner will have is the implied covenant of good faith (which, as discussed below, is a limited obligation).

- **Partnership agreement provisions requiring only specified, limited disclosure will be respected by the court.** The decision confirms that the court will respect a partnership agreement that extinguishes the general duty of disclosure (in Delaware, a corollary of the fiduciary duties of care and loyalty) in connection with a vote of unitholders to approve an affiliated transaction and replaces it with explicit disclosure requirements—even if the specified requirements are very limited (such as, in *Dieckman*, where the sole disclosure requirement was that a copy or summary of the proposed merger agreement be provided to the unitholders).

Discussion

Partnership agreement provisions. The Regency limited partnership agreement included the following:

- ***Obligation to act in good faith.*** The general partner must act in good faith—defined to mean that the persons making a determination or taking an action "must believe that [it] is in the best interests of the Partnership."

- ***Safe harbors for conflicted transactions eliminate fiduciary duties.*** An action of the general partner with respect to a conflicted transaction will not constitute a breach of the agreement "or of any duty stated or implied by law or equity" if (among other safe harbor provisions) the transaction is approved (i) by a conflicts committee of the general partner (comprised of two or more directors, none of whom are, at the same time they are serving on the conflicts committee, officers, directors, employees or security holders of the general partner or any of its affiliates); *or* (ii) by the units not held by the general partner or any of its affiliates.

- ***Presumption of good faith.*** There is a conclusive presumption of good faith when the general partner acts in reliance on the opinion of legal or financial advisors.

- ***Limited disclosure obligation.*** With respect to approval of a merger by the unaffiliated unitholders, the only disclosure requirement is that a copy or summary of the merger agreement be included with the notice of meeting or written consent.

Partnership agreement safe harbor process can shield a conflicted transaction from judicial review. The court will generally respect a partnership agreement that extinguishes the fiduciary duties of due care and loyalty with respect to affiliated transactions and provides instead for specified "safe harbor" processes for approval (such as approval by a conflicts committee or by the unaffiliated unitholders). It is to be noted that the court *will* review the extent to which the process was followed. For example, when a partnership agreement provides for a conflict committee safe harbor, the court will consider the extent to which the committee members met the requirements set forth in the partnership agreement for membership (typically relating to their independence) and met the standard set forth in the agreement for their approval of the transaction (typically relating to their subjective belief that the transaction was in the best interest of the partnership).

Partnership agreement disclosure requirements can replace general duty to disclose. The court noted that, in the *corporate* context, because the duty of disclosure "derives from the [fiduciary] duties of care and loyalty," in order for a *stockholder* vote to ratify a board action, the directors must have fully disclosed all material information to the stockholders. In the *limited partnership* context, however, the court explained, while there is a duty of full disclosure, all fiduciary duties (including the duty of disclosure) may be eliminated by contract or waived. The Chancellor refused to "read into" the partnership agreement any disclosure requirements beyond the requirement stated in the agreement. The Chancellor noted that, in the court's 2011 *K-Sea* decision, disclosure claims were dismissed on the basis that the duty of disclosure had been replaced under the partnership agreement with the obligation only to provide a copy or summary of the merger agreement—even though the partnership agreement in that case did not explicitly waive fiduciary duties *generally* (which the Regency partnership agreement did). The Chancellor also noted that the contractual elimination of state law fiduciary duties did not leave the Regency investors without recourse concerning the quality of the information they had received before voting on the merger because the federal securities laws still applied. (The plaintiff was initially part of a federal

action in which disclosure claims were made, but he chose to abandon the federal claims to pursue the contractual claims in the Court of Chancery.)

Elimination of fiduciary duties. The Chancellor—describing the Regency partnership agreement as having "eliminat[ed] fiduciary duties," and emphasizing that "the express policy of this State is to give maximum effect to the principle of freedom of contract"—confirmed that limited partnerships may, by contract, "expand or restrict the duties owed to the partnership or its partners." Given the court's broad emphasis on partnership agreements as contractual arrangements, without an overlay of fiduciary duties, the question arises whether there is *any* limit to the leeway that the court will extend to a general partner with respect to affiliated transactions so long as the partnership agreement eliminates the general partner's fiduciary duties.

Implied covenant of good faith is a limited obligation. The only duty that may *not* be extinguished under a partnership agreement is the implied covenant of good faith and fair dealing, the Chancellor wrote. The Chancellor acknowledged that "it might seem harsh to shield a conflicted transaction from judicial review under Delaware law based on a vote of unitholders without requiring the disclosure of all material information." The implied covenant does not create any additional disclosure requirements, however, but only "fills gaps by implying terms that the parties would have agreed to during their original negotiations if they had thought to address them.... If no gap exists, the implied covenant has no work to do," the Chancellor wrote. The Chancellor concluded that, in *Dieckman*, the "express waiver of fiduciary duties and the clearly defined disclosure requirement set forth in the LP Agreement prevent[ed] the implied covenant from adding any additional disclosure obligations to the agreement."

Practice Points

- **A partnership agreement should *clearly define* the extent to which the general partner's obligations and the unitholders' rights under the law are being contractually modified**. *Provisions that would be most protective for a general partner include the following:*
  - ***Elimination of fiduciary duties.*** A partnership agreement can provide that all fiduciary duties of the general partner are eliminated.
  - ***Unitholders safe harbor process for affiliated transactions.*** If a partnership agreement provides for a safe harbor process involving approval by the unaffiliated unitholders, we note that, unlike the Regency provision that called for approval by a majority of the unaffiliated units *outstanding*, the requirement could be for a majority of the unaffiliated units *voting*. (The Regency merger was approved by 67% of the unaffiliated units outstanding, which represented 99% of the unaffiliated units voting.)
  - ***Conflict committee safe harbor process for affiliated transactions.*** In almost all cases, approval by a conflicts committee of the general partner will provide the easiest and quickest safe harbor process for affiliated transactions. The partnership agreement can provide that the committee membership may be small (for example, as in *Dieckman*, two or more directors) and can define broadly the independence requirements for the members. (In *Dieckman*, the independence definition required that the committee members were not at the same time serving as directors of affiliates of the general partner. We note that it is not necessary to have such a restrictive definition of independence.)

- ***Standard for approval by conflicts committee.*** A partnership agreement can define narrowly the standard that will apply to a conflicts committee's decision to approve an affiliated transaction. Often, the standard set forth is that the persons making the decision hold a *subjective belief* that the decision is in the best interests of the partnership. In addition, a partnership agreement can include a provision that there is a conclusive presumption of good faith by the conflicts committee when it relies on an opinion provided by legal or financial advisors.

- ***Disclosure obligation.*** A partnership agreement can provide for a very limited disclosure obligation of the general partner in connection with the unitholders' approval of a transaction (such as the obligation only to provide a copy or summary of the merger agreement). Of course, disclosure obligations under the federal securities laws still would apply (but would not give rise to contractual liability under the partnership agreement).

- **Wide latitude in crafting safe harbors, but compliance with the process is key.** While, a partnership agreement can provide for very limited obligations of a general partner in connection with affiliated transactions, the process established in the agreement must be followed, and the general partner will be advantaged to the extent that the committee (notwithstanding the elimination of fiduciary duties by contract) takes its job seriously and functions well.

  Conflict committee members should:

  - meet the independence requirements for membership;

  - know the standard for the committee's approval of the transaction;

  - ensure that they have the information necessary to make a determination that meets the standard for approval;

  - be appropriately engaged in the process of considering the transaction;

  - consider retaining independent financial and legal advisors and, if advisors are retained, ask questions to ensure that the advice and analyses are understood, consider obtaining a fairness opinion or legal opinion, and remain in control of the committee process;

  - consider whether to negotiate the terms of the transaction with the parent company (unless the determination is clear, some level of negotiation with the parent company is often advisable as a basis for forming a good faith judgment about the transaction); and

  - make a determination that meets the standard for approval (tracking the language set forth in the partnership agreement with respect to the standard of approval), and memorialize their determination in the formal record of the committee's deliberations.

- **Independence of conflict committee members.** Notwithstanding the definition of independence in a partnership agreement, the more independent the members of the conflicts committee are, the more protective the process will be from a legal point of view.

- **As always, the factual context is important.** While the court extends a high degree of deference to partnership agreement provisions, the facts and circumstances can very much affect the court's result. Notably, in *Dieckman*, while the plaintiff raised issues as to the independence of

the conflict committee members, the committee engaged in a process that included obtaining unitholder approval (which was required by statute for a merger) and a fairness opinion, the pleadings did not include allegations of an egregious result, and there was no indication that the committee members had not formed the requisite belief that the transaction was in the best interests of the partnership. We note that, by contrast, in the 2015 *El Paso* situation, in the context of extreme facts relating to the conflict committee's process, the court deemed the conflict committee approval to have been ineffective—although the standard of approval was even lower than in *Dieckman*- (*i.e.,* a "*subjective* belief" that the transaction was in the best interests of the partnership). In *El Paso,* the court concluded that the committee did not in fact form a subjective view that the dropdown transaction at issue was in the best interests of the partnership. Emphasizing the incomplete, inaccurate, and "manipulative" nature of the information provided to the committee by its financial advisor, as well as the committee's ignoring information it had relating to the partnership's other recent dropdown transactions, the court's view appeared to be that the committee did not have a base of information upon which it was even *possible* to form a subjective belief as to whether the transaction was in the partnership's best interests. Notably, in *El Paso*, there was no unitholder approval and, critically, there were contemporaneous emails among the committee members that indicated that they *actually* believed that the transaction would *not* be in the best interests of the partnership.

For other practical suggestions for actions by committees (and their bankers) in conflict situations, please see the Fried Frank M&A Briefing, *Practice Points for MLP Conflict Committees, Investment Bankers, and General Partners, Arising from Most Recent* El Paso *Decision* (May 7, 2015), available on the Fried Frank website.

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