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Delaware Supreme Court Applies Good Faith Obligation to MLP General Partner in Dieckman*--But We Believe the Decision Will Have Limited Impact on GPs*

In *Dieckman v. Regency* (Jan. 20, 2017), the Delaware Supreme Court, reversing the Court of Chancery, refused to dismiss, at the pleading stage, the plaintiff MLP unitholder's claims against a general partner that had relied on "safe harbor" provisions in the master limited partnership agreement to effect a merger between the MLP and one of the general partner's affiliates. The MLP agreement provided that the general partner could effect a transaction between the MLP and the general partner or any of the general partner's affiliates if the general partner obtained approval of the transaction either by an independent conflicts committee of the general partner's board or by the unaffiliated unitholders of the MLP. The Supreme Court, hearing the case *en banc*, found that, although the MLP agreement (as is typical) disclaimed all fiduciary duties of the general partner, the implied covenant of good faith and fair dealing applied to the general partner's actions in obtaining safe harbor approvals of the conflicted transaction.

Some have commented that the decision could have significant consequences for general partners. In our view, however, the decision does not suggest that the Supreme Court intends to expand application of the implied covenant of good faith to general partners' actions more generally. Rather, we believe that the opinion is limited to establishing that the Court will view a general partner as having breached the implied covenant of good faith when the general partner engaged in "misleading or deceptive conduct" that undermined the (typically minimal) protections afforded to unitholders in an MLP agreement.

Key Points

- **General partners cannot act deceptively in obtaining safe harbor approval of conflicted transactions.** *Dieckman* does not disturb the well-established principles that all fiduciary duties of a general partner can be disclaimed, and that unitholders' rights are generally limited to those expressly set forth in the MLP agreement. In *Dieckman*, the Court found that the general partner's conduct in obtaining safe harbor approval of a conflicted merger transaction was "deceptive," "manipulative" and "misleading." In effect, the Court viewed the actions the general partner took to establish an "independent" conflicts committee as a sham that, when not disclosed to the unitholders, "undermined" the minimal protections afforded to the unitholders under the MLP agreement.

- **In our view, the decision does <u>not</u> signal that the Court intends to expand unitholders' rights or limit general partners' protections.** We expect that it will continue to be the case that unitholders' rights generally will not exceed those expressly set forth in the MLP agreement—as,

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we believe, the courts will continue to apply the implied covenant of good faith only in those situations where it is particularly warranted due to egregious actions by the general partner, such as those designed to undermine the limited protections provided by the partnership agreement. We expect that it will also continue to be the case that MLP agreements will disclaim all fiduciary duties of the general partner and will generally provide only minimal protections for unitholders—and that the courts will continue to respect such provisions.

Background

The case involved a challenge to the acquisition of Regency Energy Partners LP ("Regency") by an affiliate of its general partner in an $11 billion unit-for-unit merger (representing a 13.2% premium to the unaffected unit price). The merger was approved by a conflicts committee of the general partner's board and by the unaffiliated unitholders.

The MLP agreement safe harbor provisions. The MLP agreement included two typical "safe harbors" under either one of which the general partner could approve a transaction between the MLP and the general partner or any of its affiliates: approval by (i) an independent conflicts committee of the general partner's board, or (ii) the unaffiliated MLP unitholders. The MLP agreement required (again, as is typical) that a conflicts committee be comprised entirely of two or more directors who were *independent directors* of the general partner. The MLP agreement stated that the committee members must not be officers or employees of the general partner, nor directors, officers or employees of any affiliate of the general partner, and must meet the NYSE independence standards for service on an audit committee. The only disclosure required by the MLP agreement in connection with safe harbor approval by the unitholders was delivery to the unitholders of a summary or a copy of the transaction agreement.

The general partner's actions in forming the conflicts committee. The general partner appointed two directors to the conflicts committee considering the Regency merger. To meet the technical requirements for independence set forth in the MLP agreement, one of these directors—who had already been reviewing the merger on behalf of the MLP while a director of an affiliate of the general partner—resigned as a director of the affiliate just before being formally appointed to the committee and was then re-appointed to the affiliate's board the day the merger closed. The other member was also appointed to the board of that affiliate the day the merger closed. The 165-page proxy statement delivered to unitholders did not disclose that the committee members had been or would be directors of an affiliate of the general partner immediately before and/or after serving on the Committee.

The Court of Chancery decision. The Delaware Court of Chancery (March 29, 2016) had dismissed the plaintiff's claims at the pleading stage. Chancellor Bouchard found that all fiduciary duties of the general partner had been disclaimed in the MLP agreement; that the MLP agreement's "single disclosure requirement" of delivery of a copy of the merger agreement had been fulfilled; that the unaffiliated unitholders had approved the merger; and that the unitholders approval safe harbor therefore had been satisfied. Finding that one of the safe harbors had been satisfied, the Chancellor did not reach the issue whether the conflicts committee safe harbor had also been satisfied. The Chancellor acknowledged that the conflict of interest of the committee members was material information that had not been disclosed; and 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." However, he reasoned, the MLP agreement set forth the (albeit very limited) disclosure requirement that had to be satisfied and it was satisfied. "[T]he implied covenant [of good faith] does not create any additional disclosure requirements," he wrote, concluding: "[A]s no gap [in the terms of the agreement] exists, the implied covenant has no work to do."

The Delaware Supreme Court reversal. The Delaware Supreme Court, in an opinion written by Justice Seitz, held that the implied covenant of good faith prevented the general partner from using "deceptive conduct" to mislead unitholders into believing that an independent conflicts committee had approved the transaction when the members were not "genuinely" independent.

Discussion

MLP unitholders' rights are generally limited to the express provisions set forth in the MLP agreement. If, as is typical, an MLP agreement clearly disclaims all fiduciary duties of the general partner and provides for safe harbor approval of conflicted transactions, and if the general partner follows the safe harbor process set forth, any challenges to the transaction generally will be dismissed at the pleading stage. We expect that this will continue to be the case—absent conduct by the general partner that is so egregious as to be viewed by the court as deceptive. In *Dieckman*, Justice Seitz reiterated the buyer-beware approach that the courts have taken to MLP agreements, stating:

> With the contractual freedom accorded partnership agreement drafters, and the typical lack of competitive negotiations over agreement terms, come corresponding responsibilities on the part of investors to read carefully and understand their investment. Investors must appreciate that with the benefits of investing in alternative entities often comes the limitation of looking to the contract as the exclusive source of protective rights. In other words, investors can no longer hold the general partner to fiduciary standards of conduct, but instead must rely on the express language of the partnership agreement to sort out the rights and obligations among the general partner, the partnership, and the limited partner investors.

The only obligation a general partner has *beyond* the express provisions set forth in the MLP agreement is an implied covenant of good faith—which has been, and we believe will continue to be, interpreted narrowly by the courts. The covenant of good faith and fair dealing is implicit in every contract, is statutorily required, and cannot be disclaimed. The covenant has been interpreted by the courts as having narrow applicability, however—generally to "fill in gaps" in the terms of an agreement where developments have occurred that could not have been anticipated by the parties and it is clear what the parties would have intended had they anticipated those developments. In *Dieckman*, the Court of Chancery found that there were no gaps resulting from unexpected developments and the covenant therefore "had no work to do." The Supreme Court, however, applied the covenant, stating that it could be used to "fill in" terms that "the parties must have intended…and ha[d] only failed to express…because they [were] too obvious to need expression." Such provisions, the Court explained, were that "the General Partner will not mislead unitholders when seeking Unaffiliated Unitholder Approval" and that "the General Partner will not subvert the [Conflicts Committee] Approval process by appointing conflicted members to the Conflicts Committee." The implicit good faith requirement, the Court stated, means that the general partner cannot "act to undermine the protections afforded unitholders in the safe harbor process," by using "deceptive conduct…to create the false appearance of an unaffiliated, independent [Conflicts] Committee."

In our view, the decision does <u>not</u> signal an expansion of unitholders' rights or limitation on general partners' rights. We expect that the courts will continue to interpret the implied covenant of good faith narrowly, and that the decision does *not* suggest any intention by the Court to more generally expand unitholders' rights or limit general partner's rights. Our view is based on:

- The clear reaffirmation in the opinion that all general partner fiduciary duties can be disclaimed in an MLP agreement;
- The Court's reiteration of a buyer-beware warning to MLP potential investors, emphasizing that their rights are defined by the express terms of the MLP agreement;
- The egregious nature of the general partner's conduct in *Dieckman*, and the Court's emphasis on that conduct having been "manipulative," "deceptive," and "misleading"; and
- The strong trend of the Delaware courts over the past few years in *broadening* protections for *corporate* directors (who *do have* fiduciary duties) when a transaction has been approved by independent directors or by the stockholders in a fully informed vote.

Courts will respect MLP safe harbor provisions for approval of conflicted transactions. The typical MLP agreement provides for safe harbor approval of conflicted transactions by an independent conflicts committee of the general partner's board *or* by the unaffiliated unitholders. Independence requirements for the committee members are as set forth in the MLP agreement and, as in *Dieckman*, typically require that the members not be officers or employees of the general partner, nor be directors, officers or employees of any of the general partner's affiliates. Notably, the issues that arise in the corporate context relating to directors' personal and business relationships and ties are not relevant in the partnership context. Usually, the MLP agreement requires only minimal disclosure to unitholders in connection with their vote under a conflicted transaction safe harbor approval provision (such as, in *Dieckman*, that a summary or a copy of the transaction agreement be provided to the unitholders). If the MLP agreement clearly establishes a "safe harbor" process, and it is followed—and, as highlighted in *Dieckman*, the general partner has not been "deceptive" in obtaining the approval—then, based on compliance with the safe harbor, any challenge to the transaction should be dismissed at the pleading stage of litigation.

Increased prevalence of conflicted transactions in the current environment. Historically, MLP agreement provisions relating to affiliated transactions were important principally in connection with the dropdown of assets by a general partner to the partnership. With current difficult market conditions affecting oil and gas industry MLPs, transactions between MLPs and their affiliates have become, and are likely to remain, common. Not only dropdowns, but also rollups, insider financings, acquisition by limited partners of the general partner's incentive distribution rights, 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 MLPs.

Disclosure in the corporate and partnership contexts. We note that, in the *corporate* context, where directors *have* (and cannot disclaim) fiduciary duties to stockholders, the courts in recent years have established that, in transactions not involving a controlling stockholder, approval of a transaction by independent and disinterested directors or fully informed stockholders will "cleanse" a transaction, resulting in dismissal of post-closing challenges at the pleading stage of litigation. Further, the courts, have applied a high standard as to what information may be deemed to be "material" and thus must have been disclosed for a stockholder vote to be considered "fully informed." The courts can be expected to tend even more strongly in this direction in the *partnership* context, where general partners disclaim their fiduciary duties (so long as the general partner has not been deceptive or misleading).

Most affiliated MLP transactions do not require unitholder approval. We note that most types of conflicted transactions (such as asset dropdowns) do not require unitholder approval. In these

circumstances, a general partner typically will choose to satisfy only the conflicts committee approval safe harbor.

Materiality of information for disclosure purposes when obtaining unitholder approval. Certain types of conflicted transactions (such as mergers), under state law or the MLP agreement, cannot be effected without unitholder approval. In these cases, a general partner will have to obtain unitholder approval—and the federal proxy rules will apply, expanding the disclosure required beyond that set forth in the partnership agreement for safe harbor purposes. We expect that, in the partnership context, the courts will apply at least as high (or even a higher) standard for materiality of information when determining whether adequate disclosure was made than in the corporate context. In either context, however, a general partner cannot make false or misleading disclosure—at least with respect to information relating to the independence of conflicts committee members. In *Dieckman*, the Supreme Court found that, "[O]nce [the general partner] went beyond the minimal disclosure requirements of the LP Agreement, and issued a 165-page proxy statement to induce the unaffiliated unitholders not only to approve the merger transaction, but also to secure the Unaffiliated Approval safe harbor, implied in the language of the LP Agreement's conflict resolution provision was an obligation not to mislead unitholders." Notably, the non-disclosure at issue was (we would suggest) likely *the single most pertinent fact—i.e.,* that the merger had not been approved by an *independent* conflicts committee.

Practice Points

- **A general partner cannot act deceptively to manipulate and mislead unitholders when obtaining safe harbor approval of a conflicted transaction.** Where the MLP agreement requires that conflicts committee members not be directors, officers or employees of an affiliate of the general partner, the fact that a committee member was a director, officer or employee of such an affiliate immediately before and/or after service on the committee would appear to be material information that must be disclosed.

- **Potential investors in MLPs should understand the MLP agreement—and the typically minimal protections afforded to unitholders—before investing.** In our experience, even sophisticated investors are often unaware of the minimal nature of the protections for unitholders under a typical MLP agreement. Although the Court applied the implied covenant of good faith to the general partner in *Dieckman*, the covenant is generally narrowly interpreted by the courts and is likely to be applied only in the context of egregious conduct by the general partner.

- **Conflicts committee best practices.** While it was the composition, not the conduct, of the conflicts committee that was at issue in *Dieckman*, we note that generally 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. Committee members should:

  - meet the independence requirements for membership set forth in the MLP agreement;

  - know the standard for the committee's approval of the transaction set forth in the MLP agreement;

  - 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 (we note that, in *Dieckman*, the plaintiff claimed that the financial advisor had a conflict of interest because it was selected by the Regency CFO rather than by the committee);
- if advisors are retained, determine if they have any conflicts of interest, 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 in the MLP agreement with respect to the standard of approval); memorialize the determination in the formal record of the committee's deliberations; and be mindful that emails or other contemporaneous communications by committee members can be used to raise doubts about whether the committee actually formed the belief about the transaction required to meet the standard of approval.

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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