Delaware Supreme Court Addresses Limited Partnership Drop-Down Transactions and Conflicts Committees

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01/06/17

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The Delaware Supreme Court recently ruled on two appeals from Court of Chancery decisions involving "conflicts committees" of Delaware limited partnerships. Both decisions arise out of challenges to "drop-down" transactions involving a sale of assets from the general partner's ultimate parent, where the partnership agreement provided for a safe harbor if a specified process involving approval by an independent "conflicts committee" is followed.

In the first decision, *El Paso Pipeline GP Company, L.L.C. v. El Paso Corporation*, the Supreme Court unanimously reversed Vice Chancellor J. Travis Laster's December 2015 decision in which he held that a derivative claim challenging the drop-down transaction on behalf of the master limited partnership that had ceased to exist independently would be treated as "dual natured" so as to allow the plaintiff, a former unitholder in the master limited partnership, to continue pursuing the claim and a pro rata recovery of a $171 million damages award. In the second ruling, *Employees Retirement System of the City of St. Louis v. TC Pipelines GP, Inc.*, the Supreme Court affirmed the Court of Chancery's dismissal of a challenge to the drop-down transaction where the complaint pleaded no specific facts of improper motive, bad faith or misfeasance on the part of the conflicts committee, but merely challenged the economic fairness of the transaction. Both rulings are described below.

In April 2015, the Court of Chancery issued a post-trial opinion in *In re El Paso Pipeline Partners, L.P. Derivative Litigation*, described here, holding the general partner of El Paso Pipeline Partners, L.P. (the limited partnership) liable for $171 million in damages resulting from derivative claims challenging a drop-down transaction, based on the court's finding that the conflicts committee did not subjectively believe that the transaction was in the best interests of the limited partnership, as required by the partnership agreement. While the litigation was pending, in November 2014, Kinder Morgan acquired 100 percent of the equity of the El Paso parent entity. Thereafter, in December 2014, a related-party merger caused the limited partnership to cease existence as a separate, publicly traded entity. The general partner moved to dismiss the claims, arguing that the plaintiff unitholder had lost standing to pursue his derivative claims under Delaware's "continuous ownership" rule. The Court of Chancery denied the motion, holding that the unitholder's derivatively pleaded claim should be viewed as "dual-natured" — in other words, both derivative and direct — such that "the plaintiff [could] continue to pursue it" and receive "a pro rata recovery in favor of the limited partners at the time of the [m]erger who were not affiliated with the General Partner."

The Delaware Supreme Court reversed, holding that "the derivative plaintiffs' claims were and remain derivative in nature." The court held that Delaware's *Tooley* standard for determining whether a claim is direct or derivative applies to alternative entities such as limited partnerships even though limited partnerships are "creatures of contract." The court explained that "[t]he reality that limited partnership agreements often govern the territory that in corporate law is covered by equitable principles of fiduciary duties does not make all provisions of a limited partnership agreement enforceable by a direct claim." Applying *Tooley*'s two-pronged analysis, the Supreme Court found that the limited partnership itself — not the unitholder — was entitled to sue the general partner for a claim that the drop-down transaction was unfair to the limited partnership, since the challenged transaction "left the Partnership," not the unitholders individually, "$171 million poorer."

The Supreme Court also reversed the Court of Chancery's determination that the merger did not extinguish the unitholders' claims, explaining that, "[u]nder our law, equity holders confronted by a merger in which derivative claims will pass to the buyer have the right to challenge the merger itself as a breach of the duties that are owed. ... To make the general rule one where derivative plaintiffs can continue to sue after a merger

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would ... raise overall transaction costs and barriers to mergers, with obvious costs to public investors, with no gain substantial enough to compensate them."

Additionally, and possibly of broader application beyond the limited partnership context, the court commented on its prior opinion in *Gentile v. Rossette*, which "can be read as undercutting the traditional rule that dilution claims are classically derivative." The court majority declined to expand *Gentile* beyond its particular facts, which involved a controlling stockholder that increased its control through a dilutive transaction. In a concurrence, Chief Justice Leo E. Strine Jr. wrote separately that "*Gentile v. Rossette* is a confusing decision which muddies the clarity of our law in an important context. ... [I]t ought to be overruled."

In the Supreme Court's second ruling, *Employees Retirement System of the City of St. Louis v. TC Pipelines GP, Inc*., the limited partnership agreement provided that conflicted transactions are "conclusively deemed fair and reasonable" if approved by a conflicts committee made up of at least two independent directors. Once the committee determines the transaction is fair and reasonable, it is deemed (1) conclusively approved by limited partners, (2) not a breach of the partnership agreement and (3) not a breach of "any duty stated or implied by law or equity." The complaint challenging the drop-down transaction alleged that the transaction was not economically fair, and was less favorable to the limited partnership than two previous drop-down transactions; therefore, the committee must have acted in bad faith, violating the implied contractual covenant of good faith and fair dealing.

The Court of Chancery dismissed the complaint, noting that it did not plead any specific facts supporting improper motive, misfeasance or bad faith by the conflicts committee, but relied solely on a challenge to the transaction's economic merits. In the court's view, allowing a complaint to proceed solely because the transaction's economic merits were subject to reasonable questions would be "inconsistent with the evident purpose of the safe harbor created by the Conflicts Committee approval." The Supreme Court affirmed the Court of Chancery's decision, noting that "the appellant cannot escape the conclusive effect given to Conflicts Committee approval solely by attacking the fairness of the underlying transaction." To hold otherwise would mean that the "safe harbor would be virtually no safe harbor at all." The court likewise rejected the claims based on a breach of the implied covenant of good faith and fair dealing, holding that, because the implied covenant is narrowly applied, to invoke it, a plaintiff must allege "specific facts suggesting the Conflicts Committee process was tainted." While the court did not "rule out the possibility that future plaintiffs may invoke the implied covenant successfully in this context," the court did not identify what the plaintiff must plead to do so since "it is not the role of courts to identify future situations in which the implied covenant may be invoked."

As a result of these decisions, market participants and practitioners involved in drop-down transactions, and acquisitions of companies that have participated in such transactions, should bear in mind several key points. Notably, the process to be followed by the conflicts committee ought to be clearly spelled out in the partnership agreement or other governing document, including the resulting presumption of good faith and no breach of duty. Importantly, the committee must abide by that process faithfully in practice in order to avoid exposing the transaction to undue risk. Once such a process has been followed, Delaware courts will not second-guess the economic justification for such a transaction, absent a showing of waste. Moreover, if a company that has engaged in a drop-down transaction is subsequently acquired, derivative challenges to such transactions may no longer be brought by its former equity holders.