Another Lesson from the Delaware Chancery Court on Process in Related Party Transactions

The Delaware Chancery Court recently held the general partner of a limited partnership liable for $171 million in damages for causing the limited partnership to overpay for assets it purchased from the parent of the general partner. The Court's decision illustrates that:

- Delaware law allows the organizational documents of "alternative entities" (limited partnerships and limited liability companies) to eliminate common law fiduciary duties. But even when the contractual provisions that replace fiduciary obligations appear to impose only minimal requirements on those who control the entity, failure to properly understand and carefully follow those requirements and instead simply "going through the motions" of compliance can have calamitous consequences.
- The conduct of a financial advisor in an M&A transaction is always potentially subject to intense judicial scrutiny, even when the claims before the Court do not directly implicate the advisor's conduct. Financial advisors who take a relaxed approach in situations that appear routine or low-risk sometimes can find themselves exposed at least to unpleasant criticism, and sometimes to financial exposure.

Background

In ***In re El Paso Pipeline Partners L.P. Derivative Litig., C.A. No. 7141-VCL (Del. Ch. Apr. 20, 2015)***, the plaintiffs owned publicly traded units of limited partnership interest issued by El Paso Pipeline L.P., a Delaware limited partnership (the "MLP"). The plaintiffs challenged two "dropdown" transactions. In the challenged transactions, El Paso Corporation ("EPC"), which was the parent of the MLP's general partner (the "GP"), sold assets to the MLP. The purchases by the MLP required the approval of

the GP. Because the GP was a subsidiary of the seller, it had a conflict of interest. Resolution of the conflict was not subject to traditional fiduciary analysis because the MLP's limited partnership agreement contained provisions eliminating all the fiduciary duties that otherwise would be owed to the MLP or its partners by the GP or the GP's directors. The partnership agreement required that transactions involving conflicts of interest (such as the dropdown transactions challenged in this case) had to satisfy one of four alternative requirements. Under the requirement that the GP elected to seek to follow in this case, each transaction had to be approved by a majority of the members of a committee of independent directors of the GP "acting in good faith". The agreement further provided that for an action to be in "good faith", the actor "must believe that the …. action is in the best interests of the [MLP]". Thus, under the contractual framework that replaced standard fiduciary obligations in the MLP's partnership agreement, the committee was not required to reach any conclusion as to the fairness of a conflict transaction to the public holders of the MLP's units, nor was it required to address relative fairness as between the GP and the public investors. And its determination was not subject to an objective standard such as reasonableness – the contractual requirement would be satisfied so long as the committee members subjectively believed in good faith that each transaction reviewed by them was in the best interests of the MLP. Presumably with a view to satisfying this seemingly forgiving standard, the committee retained outside legal counsel and a financial advisor, and approved the dropdowns only after negotiating with EPC to obtain improvements to EPC's initial offer and obtaining a written fairness opinion from the financial advisor. The plaintiffs' challenge to one of the transactions went to trial. The members of the committee testified at trial that they believed the transaction was in the best interests of the MLP. The Court disbelieved their testimony, found that the conduct of the committee had failed to satisfy the conflict transaction requirements of the partnership agreement, and further found that because of that failure, the GP was liable in damages because its approval of the dropdown transaction without a valid committee approval breached the partnership agreement.

The Court's Findings Regarding the Conflicts Committee and the Financial Advisor

M&A practitioners and others seeking guidance from the Court's decision may wish to consider the following:

- The committee members' conduct suggested they did not properly understand the contractual standard they were required to satisfy. They privately expressed doubts to one another in emails about strategic aspects of the challenged dropdown such as diversification and credit risk of counterparties, but then in giving their approval they appeared to rely principally on a narrow financial metric – near-term accretion – while apparently disregarding other factors. That focus is not as strange as it might at first seem – the MLP had been formed, and had raised capital in the public markets, with the expectation that it would offer a robust level of cash distributions to investors seeking yield. But that narrow focus nonetheless did not fit well with the contractual requirement that the transaction be in the best interests of the MLP. ***Lesson for prospective conflict committee members and their advisors – take care to understand the applicable contractual standard and to devise an approach that appropriately addresses it.***
- This was but the latest in a series of transactions with EPC that the same committee, using the same advisors, had approved over a period of years, and the Court appears to have believed that the committee members were "going through the motions" (analytically, this would appear to implicate the contractual requirement that the committee's conduct be in "good faith"). The Court also focused on the apparent coziness of the relationship between the committee and EPC as well as the fact that two of the three committee members, while facially satisfying the independence definition in the partnership agreement, had a history of close relationships with EPC. ***Lesson for prospective conflict committee members and their advisors – the same requirement of spirited independence that the Delaware courts apply to corporate special committees is a useful guide even when dealing with alternative entities that have replaced traditional fiduciary requirements with less demanding standards.***

- The committee's financial advisor was not a defendant in the case, but the Court devoted a substantial portion of its opinion to a withering critique of the financial advisor's performance. Notably, the Court found the financial advisor had a regular practice of engaging in private discussions with EPC regarding the terms of the various transactions reviewed by the committee and that those discussions were not disclosed to the committee. The Court found that in some cases, the advisor gave input to EPC (not disclosed to the committee) before the applicable transaction was submitted to the committee. This undoubtedly contributed to the Court's view that the participants in these processes were simply going through the motions. The Court also found that the advisor used inappropriate valuation techniques, altered metrics and presentations over time without disclosure to the committee and used metrics and presentations inconsistently and relied almost entirely on information provided by EPC, leading the Court to conclude the advisor thought its job was to justify the terms sought by EPC rather than assist its client the committee in an objective and independent analysis of EPC's dropdown proposals. The Court also clearly felt that the committee's inappropriate reliance on an accretion analysis to justify the terms of the challenged transaction resulted at least in part from the financial advisor's flawed advice. ***Lesson for financial advisors – even in a situation where public investors expect future related party transactions, and the applicable conflict committee requirements seem formulaic and easy to satisfy, financial advisors should assume their conduct will be subject to judicial scrutiny and should plan accordingly.***

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