Potential Pitfalls in Alternative Entity Investments: No Fiduciary Duties

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October 28, 2014
National Conference on Public Employee Retirement Systems

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Common Law Fiduciary Duties Regulate Management of Corporations But Not Alternative Entities

- Directors, Managers and Controlling Stockholders of corporations are bound by common law fiduciary duties.
  - "Corporate officers and directors are not permitted to use their position of trust and confidence to further their private interests. While technically not trustees, they stand in a fiduciary relation to the corporation and its stockholders. A public policy, existing through the years, and derived from a profound knowledge of human characteristics and motives, has established a rule that demands of a corporate officer or director, peremptorily and inexorably, the most scrupulous observance of his duty, not only affirmatively to protect the interests of the corporation committed to his charge, but also to refrain from doing anything that would work injury to the corporation, or to deprive it of profit or advantage which his skill and ability might properly bring to it, or to enable it to make in the reasonable and lawful exercise of its powers. The rule that requires an undivided and unselfish loyalty to the corporation demands that there shall be no conflict between duty and self-interest." *Guth v. Loft*, 5 A.2d 503, 510 (Del. 1939)

- Directors, Managers and Controllers of alternative entities, including Limited Partnerships ("LP") and Limited Liability Companies ("LLC"), are not bound by common law fiduciary duties.
  - In 2004, Delaware amended the DRULPA ("Delaware Revised Uniform Limited Partnership Act") to permit LP Agreements to **ELIMINATE** fiduciary duties.
    - "To the extent that, at law or in equity, a partner or other person has duties (including fiduciary duties) to a limited partnership or to another partner or to another person that is a party to or is otherwise bound by a partnership agreement, the partner's or other person's duties may be expanded or restricted or eliminated by provisions in the partnership agreement; provided that the partnership agreement may not eliminate the implied contractual covenant of good faith and fair dealing." DRULPA § 17-1101(d)

- Similarly, Delaware authorizes LLCs to **ELIMINATE** fiduciary duties by contract. Section 18-1101(c) of the LLC Act provides that an LLC manager's duties (including fiduciary duties) "may be expanded or restricted or eliminated by provisions in the limited liability company agreement; provided that the limited liability company agreement may not eliminate the implied contractual covenant of good faith and fair dealing."
  - "At this point, we pause to comment on one issue that the trial court should not have reached or decided. We refer to the court's pronouncement that the Delaware Limited Liability Company Act imposes 'default' fiduciary duties upon LLC managers and controllers unless the parties to the LLC Agreement contract that such duties shall not apply. Where, as here, the dispute over whether fiduciary standards apply could be decided solely by reference to the LLC Agreement, it was improvident and unnecessary for the trial court to reach out and decide, *sua sponte*, the default fiduciary duty issue as a matter of statutory construction..." *Gatz Props., LLC v. Auriga Capital Corp.*, 59 A.3d 1206, 1218 (Del. 2012)

– Virtually all modern LPs and LLCs contractually eliminate common law fiduciary duties and substitute minimal, if any, regulatory standards such as "subjective bad faith" and conclusive safe harbors for self-dealing.
  - Contractually shift the burden of proof
  - Conclusive presumption provisions: Specific contract provisions that grant the general partner a conclusive presumption of good faith if it relied upon the opinion of an expert, such as a financial advisor's fairness opinion
  - Special Approval Provisions: Provisions requiring approval by a majority of members of the conflicts committee acting in good faith that create a safe harbor for defendants.

- The minimal contractual regulatory standards provide scant protection to public investors, particularly with respect to self-dealing by management. *See Gerber v. Enterprise Prods. Holdings, LLC,* 2012 Del. Ch. Jan. 6 2012)(LPA protections "did not provide EPE's public investors with anything resembling the protections at common law"), *rev'd in part on other grounds,* 67 A.3d 400 (Del. 2013).
- The absence of strict regulation of self-dealing in alternative entities renders investor value vulnerable and heightens investor risk.

Cases Addressing Elimination of Fiduciary Duties In Alternative Entities

- ***Allen v. Encore Energy Partners, L.P.*, 72 A.3d 93 (Del. July 22, 2013)**
  - This case involved a buyout of LP Units at little, if any, premium by the controller of the GP which also held 46% of the LP Units and employed a majority of the GP Board members. The Limited Partnership Agreement ("LPA") precluded a challenge by public LP investors unless the investor could establish subjective bad faith by the GP board committee which approved the transaction.
  - Plaintiffs, former unitholders of Encore Energy Partners LP ("Encore"), filed a class action suit challenging Encore's merger with Vanguard Natural Resources, LLC ("Vanguard"). Before the merger, Vanguard owned Encore's general partner ("Encore GP") and 46% of Encore's common units. A conflicts committee, consisting of independent members of the Encore GP board of directors, gave "Special Approval" to the merger after obtaining a fairness opinion from an investment bank. Defendants moved to dismiss. The Court of Chancery found that the only express duty under the Encore LPA was a duty to act in subjective good faith, defined as a belief that the action taken is in the best interests of Encore. Further, under the LPA, use of the Special Approval process deemed the merger not a breach of the LPA, and the grant of Special Approval was subject to a rebuttable presumption of good faith. **Because Plaintiffs failed to rebut this presumption by pleading sufficient facts to show that the conflicts committee approved the merger in subjective bad faith, the Court of Chancery dismissed the breach of duty claim**. The Court of Chancery also dismissed the claim for breach of the implied covenant of good faith and fair dealing, because the LPA did not require the transaction to be "objectively fair and reasonable" and, under the LPA, Encore GP was entitled to a conclusive presumption that it acted in good faith because it relied on the opinion of a financial advisor.

- On appeal, the Delaware Supreme Court affirmed the dismissal. The Supreme Court agreed with the Court of Chancery that the only duty under the LPA was a subjective duty to act in good faith. Thus, if Plaintiffs failed to rebut the LPA's presumption that the conflicts committee acted in subjective good faith in granting Special Approval, then entering into the merger would be deemed not to breach the LPA and no Defendant could be said to have committed such a breach. The Supreme Court held that Plaintiffs could plead a breach of that duty either by alleging sufficient facts to show (1) that the conflicts committee acted in subjective bad faith, i.e., with a belief that approving the merger was against the best interests of Encore; or (2) that the conflicts committee consciously disregarded its contractual duty to form a subjective belief that the merger was in the best interests of Encore. The Supreme Court noted, however, that "[i]t would take an extraordinary set of facts" to show the latter. The Supreme Court then held that Plaintiffs' allegations that the conflicts committee negotiated poorly and obtained only a "meager" improvement in the exchange ratio did not support a reasonable inference that the conflicts committee failed to act in subjective good faith, under either theory. Because Plaintiffs failed to rebut the presumption that the conflicts committee acted in good faith in granting Special Approval, the Supreme Court did not consider the application of the conclusive presumption of good faith for Encore GP's reliance on a financial advisor's opinion. The Supreme Court also did not consider the breach of the implied covenant claim, as Plaintiffs did not raise that claim on appeal.

- ***Gerber v. Enterprise Products Holdings, LLC*, 67 A.3d 400 (Del. June 10, 2013)**
  - In *Gerber*, former public holders of LP units of an LP argued that they did not receive fair value in connection with a series of conflicted, related-party transactions involving the LP and a wholly-owned subsidiary.
  - Plaintiff, a former unitholder in Enterprise GP Holdings, L.P. ("EPE"), filed a class action suit challenging (1) EPE's 2009 sale of a company it owned to Enterprise Products Partners, L.P. ("Enterprise Products"); and (2) the 2010 merger of EPE into a wholly owned subsidiary of Enterprise Products. An independent committee of directors from EPE's general partner, Enterprise Products Holdings, LLC ("EPE GP"), gave special approval to each transaction after obtaining a fairness opinion from an investment bank. Defendants moved to dismiss. The Court of Chancery dismissed the breach of fiduciary duty claims against EPE GP because it obtained special approval for both the 2009 sale and 2010 merger, and found that Plaintiff's breach of the implied covenant claims were barred because under EPE's Limited Partnership Agreement, EPE GP was entitled to a conclusive presumption of good faith for relying on the opinion of an investment bank. The Court of Chancery dismissed the claims against the remaining defendants because their liability was secondary to EPE GP's liability.

- On appeal, the Delaware Supreme Court affirmed the dismissal of the breach of fiduciary duty claims against EPE GP, but reversed and remanded on all other claims. **In particular, the Supreme Court found that although EPE was entitled to a conclusive presumption of good faith, that presumption applied only to the express contractual duty of "good faith" that was written into the contract, not under the implied covenant of good faith and fair dealing that applies as a matter of law.** The Supreme Court noted that the Court of Chancery found that Plaintiff adequately alleged that EPE GP acted in bad faith in the special approval process for the 2009 sale, and Defendants did not cross-appeal from that determination. It also found that Plaintiff adequately alleged that EPE GP acted in bad faith by utilizing the conclusive presumption for both the 2009 sale and the 2010 merger, due to flaws in the fairness opinions. The Supreme Court remanded the claims against the other Defendants for further analysis.
- The case was ultimately settled in October of 2014.

- ***Norton v. K-Sea Transp. Partners L.P.*, 67 A.3d 354 (Del. May 28, 2013)**
  - This case involved a merger between an LP and a third party in which the general partner of the LP was alleged to be conflicted in approving the merger because it obtained in the merger excessive consideration for incentive distribution rights ("IDRs") that it held.
  - Plaintiffs, unitholders of K-Sea Transportation Partners L.P. ("K-Sea"), filed a class action suit against K-Sea and related entities, challenging a merger between K-Sea and Kirby Corporation ("Kirby"). In addition to the per-share consideration accorded to common unitholders, the merger agreement called for a separate payment to K-Sea's general partner, K-Sea General Partner, L.P. ("K-Sea GP"), for its IDRs. The merger received special approval from a conflicts committee consisting of independent members of the board of directors of K-Sea GP's own general partner, after obtaining an opinion from an investment bank stating that the consideration to the limited partners was fair. Defendants filed a motion to dismiss, which the Court of Chancery granted and the Delaware Supreme Court affirmed.

- **The Supreme Court found that K-Sea's Limited Partnership Agreement ("LPA") granted K-Sea GP sole discretion to consent to a merger. It further found that such discretion was limited only by the contractual duty to act in, or at least not inconsistent with, the best interests of K-Sea – a duty which the Supreme Court found was indistinguishable from "good faith" for the purposes of the exculpation provision limiting Defendants' monetary liability to actions that were not taken in good faith.** The Supreme Court then held that regardless of whether the special approval process was improperly executed, as Plaintiffs alleged, the failure to obtain special approval of an interested transaction would not necessarily prove a breach of fiduciary duty because special approval is permissive and not mandatory. **Finally, the Supreme Court found that K-Sea GP was entitled to a conclusive presumption of good faith under the LPA because it relied on the opinion of an investment bank, and therefore dismissed the breach of fiduciary duty claim against K-Sea GP.** Because the remaining Defendants' liability was premised on causing K-Sea GP to breach the LPA, the Supreme Court also dismissed those claims. The Supreme Court did not address whether Plaintiffs would have a claim based on breach of the implied covenant of good faith and fair dealing, because Plaintiffs had not raised that issue on appeal.

- ***Hite Hedge LP v. El Paso Corp*., No. 7177-VCG, 2012 WL 4788658 (Del. Ch. Oct. 9, 2012)**
  - In this case, unitholders of an LP filed suit challenging a merger between the LP's general partner's parent and a third party. The LP relied on drop-down transactions from the general partner's parent and would no longer receive those drop-downs following the merger.
  - Plaintiffs, unitholders of El Paso Pipeline Partners, L.P. ("EPB"), filed suit challenging a merger between El Paso Corporation ("El Paso") and Kinder Morgan, Inc. ("Kinder Morgan"). El Paso was the parent of EPB's general partner, and EPB relied on drop-down transactions from El Paso for continued growth. After the merger, which left Kinder Morgan as the only surviving entity, it was expected that drop- downs that previously went to EPB would now go to Kinder Morgan's own master limited partnership. The court rejected Plaintiffs' claim that El Paso breached its fiduciary duty as controlling unitholder to the minority unitholders, finding that EPB's Limited Partnership Agreement ("LPA") expressly waived any fiduciary duties of the controlling unitholder to minority unitholders. The court also found that the complained-of conduct, alleged withholding of drop-downs from EPB, arose from El Paso's control over its own assets, not control over EPB. Finally, the court found that even if El Paso was acting as controller, EPB's LPA did not give it the right to continue receiving drop downs.
  - The case was dismissed with prejudice following this opinion.

- ***Lonergan v. EPE Holdings., LLC*, 5 A.3d 1008 (Del. Ch. 2010)**
  - In this case, an LP unitholder brought a class action challenging the merger between the LP and a second publicly traded Delaware MLP, which was controlled by the LP through 100% ownership of the second LP's general partner.
  - Plaintiff, a unitholder in Enterprise GP Holdings, L.P. ("Enterprise"), filed a motion for an expedited preliminary injunction hearing in a class action lawsuit challenging a proposed merger with an affiliated partnership. The merger was approved by Enterprise's Audit Committee, which was one of four options in the Limited Partnership Agreement ("LPA") for approving interested transactions. Plaintiff alleged breach of the implied covenant of good faith and fair dealing, claiming that (1) there was not a fair and adequate sale process; (2) a majority of the minority should have been required to approve the transaction; and (3) material information regarding the merger was not disclosed. **In denying the motion to expedite, the court found that Plaintiff's claims were really breach of fiduciary duty claims, and Plaintiff could not circumvent the LPA's express waiver of fiduciary duties by rebranding them as breach of the implied covenant claims.** The court also noted that the implied covenant does apply to the Special Approval process, but Plaintiff had not pled facts to support that the Audit Committee acted in bad faith or arbitrarily in approving the merger.
  - The case was dismissed without prejudice in March of 2011.

- ***Brinckerhoff v. Tex. E. Prods. Pipeline Co., LLC*, 986 A.2d 370 (Del. Ch. 2010)**
  - In this case, unitholders of an LP challenged two transactions between the LP and a second LP. The unitholders also challenged a merger between the two LPs. There was significant ownership and control overlap between the two LPs.
  - In *Brinckerhoff*, the Delaware Court of Chancery was asked to approve a settlement of two actions. The first action included a count alleging breaches of fiduciary duties in connection with a master limited partnership's engaging in a joint venture transaction and an asset sale. There was significant ownership and control overlap between the master limited partnership and the joint venture partner and buyer. The second action arose out of a challenge by the Plaintiffs to a merger of two entities controlled by the Defendant, which the Plaintiffs claimed was effectuated by the Defendant solely to extinguish the Plaintiffs' standing to maintain the first action. As this was a decision to approve a settlement agreement, the Court did not render any final decisions regarding the Plaintiffs' fiduciary duty claims, but rather discussed the strength of potential arguments made by each side in determining the appropriateness of the settlement agreement.

- In evaluating the settlement, Vice Chancellor Laster noted the strength of the Plaintiffs' underlying claims of breaches of fiduciary duties. As part of their case, the Plaintiffs relied on a provision of the applicable LP agreement that specifically provided that transactions between affiliates under the LP agreement be "fair and reasonable" and on terms "no less favorable to [the partnership] than those generally being provided to or available from unrelated third parties." The Defendants argued that provisions of the LP agreement providing the general partner with general managerial authority and defining "sole discretion" protected the Defendants' actions. The Court was not persuaded by the Defendants' interpretation, finding that the provision specifically addressing affiliated transactions controlled the issue because, from a contractual interpretation standpoint, the more specific provision controls over a general provision.
- **While the Court felt that the Plaintiff had strong arguments as to why the affiliated transaction provision had been breached, it did not feel that claims styled as common law breach of fiduciary duty claims would succeed. The Court acknowledged that the LP Act permits parties to limit or eliminate fiduciary duties. As a result, the Court believed that the affiliate transaction provision replaced common law fiduciary duties.**
- The Court entered a final order approving the settlement.