Delaware Chancery Ruling Offers 171 Million Reasons to Address Inherent Conflicts of Interest in Delaware Limited Partnerships

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Delaware law provides that (except for the covenant of good faith and fair dealing) duties, including fiduciary duties, may be "expanded or restricted or eliminated by provisions in the partnership agreement" (6 *Del. C.* §17-1101(d)). A recent opinion issued by the Delaware Court of Chancery, however, reinforces the importance of both the careful drafting required in modifying any such duties and the utmost care needed in ensuring compliance with the remaining duties. That decision, *In re El Paso Pipeline Partners, L.P. Derivative Litigation*, cost the general partner $171 million for failure to ensure the latter.

The backdrop was the sale by the parent company, El Paso Corporation, of two of its subsidiaries to El Paso Pipeline Partners, L.P. (the "partnership"). At the time, the parent controlled the partnership through its ownership of the general partner El Paso Pipeline GP Company, LLC. The sale was structured as a two-step "dropdown" – the "Spring Dropdown" and the "Fall Dropdown." Only the Fall Dropdown was at issue, the court having previously granted summary judgment in the defendants' favor on the Spring Dropdown.

Because the parent controlled the partnership through the general partner, and because the parent owned the assets that the partnership would be acquiring, the Fall Dropdown created a conflict of interest for the general partner. The partnership's limited partnership agreement permitted such transactions with special approval, i.e., the approval by a majority of a conflicts committee believing in good faith that the transaction was in the best interest of the partnership.

The Chancery Court's View

The court held that, generally, the committee members and their financial advisor had few explanations for what they did, and the few that were offered were conclusory or contradicted by contemporaneous documents. The court held further that instead of evaluating what was in the best interest of the partnership, the committee members "regarded as dispositive whether the Fall Dropdown was accretive, in the sense of enabling [the partnership] to increase distributions to holders of its common

units." As the court pointed out, "transactions can be structured to be EPS accretive even if they destroy value for the shareholder."

Of particular interest to the court:

- The committee and its advisor used the same valuation analysis for the Fall Dropdown, which involved an acquisition of a minority stake, and the Spring Dropdown, which involved a controlling stake, and
- That by the time the committee approved the Fall Dropdown, there was evidence that the Spring Dropdown had been improperly valued.

The committee was not required to make a determination about the best interests of the common unit holders as a class or to prioritize their interests over those of other constituents. Rather, the partnership agreement required that the committee members believe subjectively that the Fall Dropdown was in the best interests of the partnership. Instead, in the court's view, the committee viewed the partnership as a controlled company that existed to benefit the parent by providing a tax-advantaged source of inexpensive capital. Because the committee members "failed to form a subjective belief that the Fall Dropdown was in the best interests of [the partnership]," the general partner breached the partnership agreement by entering into the transaction, the court held.

The court arrived at damages of $171 million by adopting an expert valuation of the amount the partnership overpaid for the Fall Dropdown. Given Delaware's express policy of giving "maximum effect to the principle of freedom of contract and to the enforceability of partnership agreements," careful drafting of the partnership agreement and/or adhering to the partnership agreement's requirements for conflicted transactions could have avoided this result. In this case, the partnership agreement required the General Partner to "act in the best interests of the partnership." However, the outcome of this case could have been different if the agreement permitted the General Partner to "act according to its own discretion." As the court pointed out, "in situations where the General Partner is authorized to act according to its own discretion, there is no requirement that the general partner consider the interests of the limited partners in resolution of a conflict of interest." Delaware law is clear that, while the implied covenant of good faith and fair dealing cannot be eliminated, it also cannot be used to contradict the express language of a governing agreement, including express modifications or waivers of fiduciary duties. As a result, in an earlier decision, the Court had rejected plaintiff's implied covenant of good faith and fair dealing claim.

What This Means To You

The El Paso transaction and the court's view are noteworthy for anyone structuring or operating a Delaware limited partnership, and particularly for private equity funds, which often utilize partnership structures as investment vehicles. Specifically for private equity funds, this case serves as a reminder that – subject to the requirements of Delaware's implied covenant of good faith and fair dealing – modifications of fiduciary duties at the fund level may permit controlling persons to mitigate their potential risk and enable them to act in their various capacities in managing the affairs of the general partner, the fund and its investments.