

Pleading Breach of the Implied Covenant of Good Faith and Fair Dealing in the Publicly Traded Master Limited Partnership Context

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In *Dieckman v. Regency GP LP*, — A.3d —, 2017 WL 243361 (Del. Jan. 20, 2017), the Delaware Supreme Court reversed the Court of Chancery^[1] and held that the common unitholder plaintiff's complaint properly stated a claim for breach of the safe harbor provisions of defendant Regency Energy Partners LP's master limited partnership agreement (the "MLP Agreement") in connection with a merger of the defendant (itself an MLP) with an affiliated entity. The Delaware Supreme Court rejected the defendant's arguments that the MLP complied with the terms of the MLP Agreement and held that, at the pleadings stage, the implied covenant of good faith and fair dealing served to fill a "gap" in the agreement in order to "vindicate the apparent intentions and reasonable expectations of the parties."

Factually, in *Dieckman*, the general partner of the MLP proposed that another limited partnership within the MLP family of entities acquire the MLP via merger. Such a transaction presented a conflict of interest because, due to the nature of the MLP structure, both the seller and buyer shared a common indirect owner. Because such conflicts of interest often arise in the master limited partner context, the MLP Agreement contained special safe harbor provisions that, if properly used, would prevent the transaction from constituting a breach of the MLP Agreement and thus insulate the merger transaction from judicial review. In this instance, the MLP Agreement contained two different safe harbor provisions: (1) a provision allowing for the "Special Approval" of a conflicted transaction by an independent conflicts committee (the "Conflicts Committee"); and (2) a provision allowing for the "Unaffiliated Unitholder Approval" of a conflicted transaction. The Special Approval safe harbor provided that a conflicted transaction will not result in a breach of the MLP Agreement if the conflicted transaction is approved by a Conflicts Committee composed of independent members. To be independent under the MLP Agreement, the Conflicts Committee members (1) could not be serving on the board of any entity affiliated with the MLP and (2) must meet the independence requirements under the audit committee independence rules of the New York Stock Exchange. The Unaffiliated Unitholder Approval safe harbor provided that a conflicted transaction will not result in a breach of the MLP Agreement if a majority of the unitholders unaffiliated with the general partner and/or its affiliates approve the

transaction. Further, under the MLP Agreement, the safe harbor provisions are disjunctive, meaning that if either the Special Approval provision or the Unaffiliated Unitholder Approval provision is satisfied, then the transaction will not be a breach of the MLP Agreement and, thus, will be immune from judicial review.

Here the plaintiff alleged that the merger violated the MLP Agreement because (1) the general partner failed to satisfy the “Special Approval” safe harbor provision because one of the two members of the Conflicts Committee was not “independent” under the terms of the MLP Agreement; and (2) the general partner failed to satisfy the Unaffiliated Unitholder Approval safe harbor because it made false and misleading statements in the proxy statement it filed and issued in connection with the Unitholder approval. The general partner moved to dismiss for failure to state a claim, arguing that the complaint failed to allege a breach of the safe harbor provisions. In deciding the motion, the Court of Chancery declined to address the Special Approval provision and held that the Unaffiliated Unitholder Approval safe harbor was satisfied. The Court of Chancery arrived at that determination because (1) the MLP Agreement disclaimed all fiduciary duties, including the duty of disclosure; and (2) the proxy statement met the minimal disclosure requirements mandated by the MLP Agreement.

On appeal, the Delaware Supreme Court first noted that even where a limited partnership agreement waives all fiduciary duties, Delaware law still provides investors in publicly traded limited partnerships with some protections. Investors are protected by the contract interpretation principle that any ambiguities in the partnership agreement will be construed against the drafter to give effect to the reading that best fulfills the reasonable expectations an investor would have, *i.e.*, *contra proferentem*, and by the implied covenant of good faith and fair dealing. In reversing the Court of Chancery, the Supreme Court noted that the lower court “focused too narrowly” on the MLP Agreement’s disclosure requirements. Rather, the focus must be on the safe harbor process in its entirety. The Delaware Supreme court, relying on the implied covenant of good faith and fair dealing, held that the MLP Agreement’s conflict resolution provision implicitly required that the general partner not act in a manner that would undermine the protections provided to the public unitholders.

With respect to the Special Approval safe harbor, the Supreme Court held that the implied covenant of good faith and fair dealing obligated the general partner to create a Conflicts Committee whose members genuinely met the criteria for independence under the MLP Agreement. “Implicit in the express terms [of the MLP Agreement] is that the [Conflicts] Committee membership be genuinely comprised of qualified members and that deceptive conduct not be used to create the false appearance of an unaffiliated, independent ... Committee.” Because the plaintiff alleged that the general partner formed a two-member Conflicts Committee that included an individual that was not unaffiliated when he began his service on the Conflicts Committee, and thus not independent as per the MLP Agreement, the Supreme Court held that the plaintiff had sufficiently pled facts to call into question whether the Special Approval safe harbor provision could apply to cleanse the merger transaction.

With respect to the Unaffiliated Unitholder Approval safe harbor, the Supreme Court noted that even though the MLP Agreement only required minimal disclosure – “not the full range of disclosure obligations that a corporate fiduciary would have,” the general partner voluntarily chose to go well beyond that by issuing a 165-page proxy statement. The Supreme Court held that once the general partner went beyond the contractually required disclosure, the implied covenant of good faith and fair dealing obligated the general partner not to mislead the unitholders and undermine the protections contained in the safe harbor provisions. The Supreme Court found that the plaintiff pled facts sufficient to state a claim that the proxy misled the unitholder by creating the false appearance that both members of the Conflicts Committee were “independent” pursuant to the criteria outlined in the MLP Agreement.

Dieckman serves as a reminder that even though Delaware limited partnerships are granted wide contractual freedom, including the freedom to disclaim all fiduciary duties, they cannot disclaim the implied covenant of good faith and fair dealing. Accordingly, in the limited partnership context, the implied covenant of good faith and fair dealing under Delaware law will not allow a general partner to act in a manner that will frustrate the “fruits of the bargain” that the public unitholders reasonably expected.

[1] The Court of Chancery’s opinion is *Dieckman v. Regency GP LP*, 2016 WL 1223348 (Del. Ch. Mar. 29, 2016).