Delaware Chancery Court Dismisses Challenge to MLP Drop Down Transaction

Article By:

William S. Anderson

Bradley J. Benoit

Ian R. Brown

The Delaware Chancery Court recently dismissed a challenge to a transaction in which a master limited partnership (the "MLP") repurchased an interest in a crude oil pipeline in 2015 previously sold to its general partner (the "General Partner") in 2009. The plaintiff alleged that the defendants, in the course of approving the transaction, breached the MLP's limited partnership agreement, the implied covenant of good faith and fair dealing and default fiduciary duties. In finding for the defendants, the court concluded that under the applicable standard set forth in the limited partnership agreement, only actions taken in bad faith could subject the defendants to liability. The court held that the complaint failed to adequately plead facts that would allow a reasonable inference that the defendants acted in bad faith and therefore the court dismissed all claims. The decision reaffirms that Delaware courts will continue to give effect to contractual governance standards contained in MLP limited partnership agreements that modify or displace common law fiduciary duties.

Initial Sale to the General Partner in 2009 The case, *Brinckerhoff v. Enbridge Energy Co.*, which was decided on April 29, 2016, is the fourth in a series of legal challenges instituted by the plaintiff arising from the creation of a joint venture in 2009 (the "2009 Sale") between the MLP and its General Partner pursuant to which the General Partner acquired an interest in a crude oil pipeline project (the "Pipeline Interest") for $800 million representing a 7x EBITDA multiple. In response to the 2009 Sale, the plaintiff filed a complaint in Delaware Chancery Court essentially asserting that the joint venture was unfair to the MLP's unaffiliated unitholders because the General Partner, through a flawed special committee process, allowed the sponsor of the MLP to pay too little for the Pipeline Interest. The Delaware Chancery Court dismissed the complaint in 2011 after concluding that the MLP's limited partnership agreement effectively replaced all fiduciary duties with a contractual governance scheme and that the plaintiff had failed to plead a violation of the only contractual standard by which the defendants' conduct could be measured: bad faith. The Delaware Supreme Court affirmed.

Repurchase by the MLP in 2015 In September 2014, the sponsor proposed that the MLP repurchase the Pipeline Interest, excluding the expansion rights, for a total price of $915 million (later increased to $1 billion). The purchase price ultimately consisted of a new class of MLP partnership securities valued at $694 million and the repayment of an outstanding loan made by the General Partner to the MLP in the amount of $306 million. Also, as part of the transaction, the General Partner would amend the limited partnership agreement so as to allocate to the public unitholders significant items of gross income that would otherwise have been allocated to the General Partner (the "Special Tax Allocation").

In response to the sponsor's proposal, a Special Committee consisting of independent directors was formed to consider whether the terms of the offer were fair and reasonable to the MLP and its unitholders and whether the MLP should proceed with the proposed transaction or seek alternatives. The Special Committee hired legal counsel and an investment banking firm with expertise in the energy industry as its financial advisor. After several meetings with the Special Committee during which it made detailed presentations, including at least three that addressed the Special Tax Allocation, the financial advisor rendered a fairness opinion to the Special Committee concluding that the transaction was fair to the MLP and to the holders of the MLP's common units (other than the General Partner and its affiliates) from a financial point of view. The Special Committee recommended, and the Board of Directors of the General Partner approved, the transaction. The transaction closed in early 2015.

Allegations of Duty Breaches The complaint claimed, among other things, that the defendants had breached express or implied fiduciary duties by failing to secure a fair price for the Pipeline Interest. The plaintiff alleged that the General Partner breached the limited partnership agreement because the transaction was not "fair and reasonable" to the MLP as it was on terms "less favorable to the Partnership than those generally being provided to or available from unrelated third parties."

The plaintiff asserted that the General Partner sold the Pipeline Interest (excluding the expansion rights) back to the MLP for $200 million more than the 2009 Sale and at a price that did not include the value of the Special Tax Allocation to the General Partner. The plaintiff further asserted that the Special Committee's financial advisor failed to consider the 2009 Sale when running its comparables analysis and failed to suggest that the Special Committee consider the cost to the public unitholders of the Special Tax Allocation or the exclusion from the transaction of the expansion rights when evaluating the fairness of the transaction price.

In finding for the defendants, the court concluded that under the applicable standard set forth in the limited partnership agreement, only actions taken in bad faith could subject the defendants to liability. Finding the plaintiff had failed to plead facts that would allow an inference that the defendants acted in bad faith in approving the transaction, the court dismissed the claims. The court noted that upon receipt of the sponsor's offer to sell the Pipeline Interest, the General Partner immediately formed a Special Committee consisting of independent directors to evaluate the transaction and consider alternatives. The Special Committee, in turn, engaged legal and financial advisors to assist in its evaluative process, and the court found that the financial advisor's review was thorough. Although the court accepted as true the allegation that the financial advisor did not consider the 2009 Sale when rendering its fairness opinion, the court found that the financial advisor considered 27 comparable transactions announced between 2011 and 2014, and that the implied transaction value to EBITDA multiple of 10.7x for the Pipeline Interest was within the range of comparable pipeline transaction multiples the financial advisor reviewed. The court also noted that the financial advisor met multiple times with the Special Committee and engaged in multiple due diligence calls with the sponsor to discuss financial projections and transaction tax treatment. Accordingly, the court concluded that the plaintiff's allegations were insufficient to plead bad faith. Although the court agreed that under the specific terms of the limited partnership agreement, the defendants were entitled to a presumption of good faith, it determined that the plaintiff's failure to adequately plead bad faith was sufficient to warrant dismissal of the claims with or without the presumption.

Special Tax Allocation The plaintiff also asserted that the Special Committee's approval of the Special Tax Allocation and the corresponding amendment to the limited partnership agreement violated express and implied duties under the limited partnership agreement. The limited partnership agreement authorized the General Partner to issue additional partnership securities and fix allocations of items of partnership income with respect to any newly issued units. The plaintiff asserted, however, that the Special Tax Allocation was a special allocation for federal income tax purposes and that the limited partnership agreement authorizes the General Partner to "make special allocations for federal income tax purposes of income . . . or deductions" only to the extent such allocations "would not have a material adverse effect on the Partners [or] the holders of any class or classes of Units." The plaintiff asserted that the Special Tax Allocation violates this provision because, according to the plaintiff, the allocation shifts over $500 million of taxable income from the General Partner to the public unitholders over a 22-year period, and then continues, at $12.4 million per year, in perpetuity. The plaintiff also asserted that the Special Tax Allocation violates the limited partnership agreement by impermissibly "enlarg[ing] the Limited Partners' obligations" by "negat[ing] most of the accretion to the Public Unitholders [they] would otherwise obtain from the Transaction."

The court concluded that the Special Tax Allocation should not be viewed in isolation and determined that the allocation was an integral component of the overall transaction and that the court must apply the limited partnership agreement's good faith standard when reviewing the propriety of the defendants' conduct in adopting or causing the MLP to adopt the implementing amendment to the limited partnership agreement. The court found that the plaintiff must plead not only a breach of the limited partnership agreement's provisions relating to the issuance of new securities and allocation of partnership income but also that such breaches were committed in bad faith.

The court found that the plaintiff had not attempted to plead facts from which the court may reasonably infer that the General Partner, in bad faith, created a "material adverse effect on the Partners [or] the holders of any class or classes of Units," or in bad faith "enlarge[d] the obligations of any Limited Partner." In the absence of allegations of a bad faith breach of the limited partnership agreement, the court found that the defendants are shielded from liability for any adverse effect or obligation created by the Special Tax Allocation.

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