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Applying Delaware Contract Law To LPA Safe Harbors

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September 20, 2017, 12:49 PM EDT


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Practitioners in the area of private fund litigation should be thankful for the existence of the Delaware master limited partnership (MLP). MLPs are investment entities created in the petroleum transportation business that provide favorable tax treatment for sponsors and public investors.[1] Like the Delaware limited partnerships that are the preferred business entities for the majority of private investment funds in the United States, MLPs are operated under and governed by limited partnership agreements (LPAs). With their intricate interrelated structures and tendency to engage in self-dealing internal transactions, MLPs are recurring vehicles for the Delaware courts to examine LPA "safe-harbor provisions" intended to shield such transactions from unfairness claims by investors. Thus, the litigation MLPs generate provide private fund attorneys with important guidance on how the Delaware Court of Chancery will construe safe harbor provisions in all varieties of LPAs.

In the recent opinion of Morris v. Spectra Energy Partners (De) GP, LP, No. CV 12110-VCG, (Del. Ch. June 27, 2017), Vice Chancellor Sam Glasscock III delivers that guidance in a thorough review of an MLP's safe-harbor provisions that ends with a limited partner having successfully stated a claim for breach of the LPA with regard to a conflicted transaction between the MLP's general partner and its parent. Vice Chancellor Glasscock's analysis is broadly applicable to Delaware LPA safe-harbor provisions in general and, for that reason, Morris invites close review by both private fund litigators and drafters of Delaware LPAs.

Delaware LPAs Replace Fiduciary Duties with Contractual Provisions

The Delaware Revised Uniform Limited Partnership Act provides that an LPA may disclaim fiduciary duties (apart from the implied covenant of good faith and fair dealing) and replace them with contractual duties.[2] The Supreme Court of Delaware holds: "If fiduciary duties have been validly disclaimed, the limited partners cannot rely on traditional fiduciary principles to regulate the general partner's conduct. Instead, they must look exclusively to the LPA's complex provisions to understand their rights and remedies."[3] This presents a challenge to practitioners and the courts in construing LPA safe-harbor provisions insofar as the provisions will usually incorporate common features but differ in subtle but significant ways. These "nuanced differences" in "an area of law defined by expansive contractual freedom require[] a nuanced analysis and renders deriving 'general principles' a cautious enterprise."[4] Nevertheless, the Morris opinion illustrates how these different and nuanced LPA safe-

harbor provisions may be predictably interpreted by applying general principles of Delaware contract law, even if identifying principles specific to construing LPA safe-harbor provisions proves problematic.

The Parties and Claims

In Morris, the plaintiff is a unit holder in an MLP called Spectra Energy Partners LP (SEP), and challenges a so-called "reverse dropdown"[5] wherein SEP sold a one-third interest in two pipeline companies back to Spectra Energy Corp. (SE Corp) — its corporate parent (and owner of approximately 80 percent equity interest in SEP). The complaint alleges that SE Corp had already publicly promised to contribute the interest in the two pipeline companies to a joint venture with a third party at an implied value of $1.5 billon. According to the complaint, SE Corp actually tendered to SEP consideration valued at less than $1 billion in exchange for the interest in the pipeline companies. Morris considers three derivative claims — breach of the LPA against Spectra Energy Partners (DE) GP, LP (SEP GP) (SEP's general partner); breach of the implied covenant of good faith and fair dealing against SEP GP; and a claim against SE Corp for tortious interference with the LPA. The defendants moved to dismiss those claims pursuant to Court of Chancery Rule 12(b)(6).[6] Following substantial briefing and oral argument, the court ruled on the motion.

The Relevant LPA Safe-Harbor Provisions

The Delaware Supreme Court instructs: "When fiduciary duties are disclaimed, 'a threshold matter when evaluating a proposed transaction under [an] LPA' is what provision of the LPA controls and whether the plaintiff has stated a claim that the defendants breached such provision."[7] The LPA in Morris contains safe-harbor provisions Vice Chancellor Glasscock characterizes as "typical." He begins his analysis with the provision the plaintiff claims is applicable to the transaction being challenged:

> Section 7.9(e) of the LPA eliminates common law fiduciary duties and replaces them with contractual standards. Section 7.9(b) of the LPA imposes a general, overarching, obligation of "good faith" on SEP GP and the Conflicts Committee whenever they "make [a] determination or take or decline to take such other action ...." Under the LPA, in order for a determination to be made in "good faith," the person acting "must believe that the determination or other action is in the best interests of the Partnership." That is, subjective good faith is the applicable standard.

The Court notes that Section 7.9 provides that the presumption of subjective good faith is rebuttable:

> Section 7.9(a) provides that the Conflicts Committee is presumed to satisfy the good faith obligation if Special Approval is received. That presumption is rebuttable; Section 7.9(a) places the burden of overcoming the presumption of good faith of the Conflicts Committee upon a person challenging the Special Approval.

Defendant SEP GP, on the other hand, identifies Section 7.10(b) of the LPA titled "Other Matters Concerning the General Partner" as the relevant provision. That section provides:

> … [t]he General Partner may consult with legal counsel, accountants, appraisers, management consultants, investment bankers and other consultants and advisors selected by it, and any act taken or omitted to be taken in reliance upon the opinion (including an Opinion of Counsel) of such Persons as to matters that the General Partner reasonably believes to be within such Person's professional or expert competence shall be conclusively presumed to have been done or omitted in good faith and in accordance with such opinion.

Vice Chancellor Glasscock reads Section 7.10(b) as "providing a general and broad conclusive presumption of good faith to SEP GP when it acts in reliance on professional advisors." Thus, the core of the dispute between the parties is over "[w]hich presumption [of good faith] applies — the rebuttable presumption of Section 7.9(a), or the conclusive presumption of Section 7.10(b)."[8]

Application of Delaware Contract Law to the LPA

Having framed the issue, the court then applies straightforward rules of contact construction to resolve the dispute over which provision applies to the challenged transaction. Vice Chancellor Glasscock begins by remarking that he is to "construe the LPA 'to give effect to the parties' intent,' interpreting words according to their plain meaning 'unless it appears that the parties intended a special meaning,' and to read the LPA as a whole to 'give effect to every provision if it is reasonably possible to do so.'"[9] Further, if "a provision of the LPA is ambiguous, since the limited partners did not bargain for its terms, ambiguities will be interpreted against the general partner, and the court will give effect to the reasonable expectation of investors."[10] Turning to the particular LPA provisions at issue, the court credits the "principle of contract construction that specific provisions of a LPA control over the more general ones"[11] and finds "that Section 7.10(b) is inapplicable as a more general provision of the LPA that 'cannot logically apply to conflict-of-interest transactions' governed by the more specific provision of Section 7.9." Citing to the Delaware Supreme Court case of Brinckerhoff v. Enbridge Energy Co. Inc. (Brinkerhoff V),[12] Vice Chancellor Glasscock holds that "the settled rules of contract interpretation counsel the Court to prefer Section 7.9(a), a specific provision, over the more general Section 7.10."[13]

Determination of Claims

The appropriate safe harbor provision having been determined, the court rules that the plaintiff has successfully rebutted the presumption of good faith by pleading facts "upon which he could recover upon a developed record." In particular, the court finds the allegation that the transaction was approved "in the face of a half-a-billion — one-third — gulf in value" implies that approval of the transaction by the conflicts committee was in subjective bad faith.[xiv] Accordingly, Vice Chancellor Glasscock sustains the claim for breach of the LPA.

The finding that the breach of the LPA claims is well pled, however, dooms the breach of implied covenant claim because there is no reason to imply a covenant in a contract where an express provision is found to have been breached: "[I]f the transaction is subject to review under the rebuttable presumption there is obviously no gap to fill in the LPA, and here there is no work for the implied covenant to do."[15]

Lastly, the court dismisses the tortious interference claim against SE Corp, reasoning that "the offer was consistent with the LPA, and it was up to the General Partner [SEP GP] to accept or reject the offer, contractually limited by a subjective good faith belief that its actions were in the best interest of the Partnership."[16]

Thus, Vice Chancellor Glasscock decides that plaintiff Morris survives the motion in part and, in the process, provides a road map for the litigation of LPA safe-harbor provisions in the Delaware courts.

Lessons for Litigation of LPA Safe-Harbor Provisions

Contractual safe-harbor provisions are the proverbial doorways through which conflicted transactions must pass in order to escape liability. In litigation challenging conflicted transactions under an LPA, the

prevailing party on a motion to dismiss must first convince the court it has identified the appropriate doorway for consideration. In that regard, general rules of contract construction should be brought to bear in addition to Delaware law specific to private contractual entities. These general contract rules will likely have exceptional resonance given that the safe harbor provisions in cases under the Delaware Revised Uniform Limited Partnership Act "require[] a nuanced analysis and render[] deriving 'general principles' a cautious enterprise."

Second, detailed allegations specifying how the challenged transaction either fails or succeeds in meeting the requirements of the appropriate safe harbor provision are essential in private fund conflicted transaction litigation. Even more so where, as in Morris, the crucial inquiry is subjective "good faith" and "objective factors may inform an analysis of a defendant's subjective belief to the extent they bear on the defendant's credibility when asserting that belief."[17] Here, the plaintiff's counsel should be credited with authoring a complaint that succeeded in pleading facts "making it reasonably conceivable that a set of circumstances exist upon which he could recover upon a developed record."[18]

Lastly, a defendant that successfully demonstrates that a conflicted transaction qualifies for a safe-harbor provision's conclusive presumption of good faith should still be prepared to confront a claim that it violated the implied covenant of good faith and fair dealing.[19] Vice Chancellor Glasscock indicates in Morris that had SEP GP convinced him that a conclusive presumption applied, he might have then turned to the implied covenant in order to provide a remedy to the limited partners: "I note were this LPA read to attach the conclusive presumption, it may be necessary to revisit the implied covenant claim which I reject below in light of my finding that only the rebuttable presumption attaches and there is therefore no gap to fill."[20] It would therefore be insufficient for a defendant to show that a conflicted transaction checks every box for a conclusive presumption of good faith if the transaction still appears to "frustrate[e] the fruits of the bargain that the asserting party reasonably expected."[21]

Because "it is clear that Delaware serves as the most likely location for private funds in the United States,"[22] Delaware's limited partnership law will continue to play an outsized role in private fund investor litigation. Further, Delaware's Court of Chancery — with its experienced and sophisticated bench — will continue to be the favored forum for the resolution of private fund disputes. Morris makes clear, however, that notwithstanding the tangled nature of the entity or the complexity of the transactions at issue, the fundamental rules of Delaware's contract law provide a well-marked path for the determination of private fund contractual duties.

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[1] Brinckerhoff v. Enbridge Energy Co. Inc., 159 A.3d 242, 245 (Del. 2017), as revised (Mar. 28, 2017) (Brinkerhoff V).

[2] 6 Del. C. § 17–1101(d).

[3] Brinkerhoff V, 159 A.3d at 252–53, citing, Gotham Partners LP v. Hallwood Realty Partners LP, 817

A.2d 160, 171 (Del. 2002)

[4] El Paso Pipeline GP Co. LLC v. Brinckerhoff, 152 A.3d 1248, 1257 (Del. 2016) (Brinckerhoff IV).

[5] A “dropdown” refers to a transaction in which an MLP purchases assets from its general partner or a related entity. Occasionally, as is the case here, an MLP may sell assets back to its general partner or a related entity in a so-called “reverse dropdown.” 2017 WL 2774559, at *2.

[6] The standard of review for a Rule 12(b)(6) motion is: (i) all well-pled factual allegations are accepted as true; (ii) even vague allegations are well-pled if they give the opposing party notice of the claim; (iii) the court must draw all reasonable inferences in favor of the nonmoving party; and (iv) dismissal is inappropriate unless the plaintiff would not be entitled to recover under any reasonably conceivable set of circumstances susceptible of proof. Savor Inc. v. FMR Corp., 812 A.2d 894, 896–97 (Del. 2002).

[7] 2017 WL 2774559, at *9 (quoting Brinkerhoff V, 2017 WL 1046224, at 8).

[8] 2017 WL 2774559, at *6–7.

[9] Allen v. Encore Energy Partners LP, 72 A.3d 93, 104 (Del. 2013).

[10] 2017 WL 2774559, at *9 citing, Dieckman v. Regency GP LP, 155 A.3d 358, 366 (Del. 2017).

[11] DCV Hldgs. Inc. v. ConAgra Inc., 889 A.2d 954, 961 (Del. 2005); Wood v. Coastal Gas Corp., 401 A.2d 932, 941 (Del. 1979).

[12] 2017 WL 1046224, at *9.

[13] 2017 WL 2774559, at *11.

[14] 2017 WL 2774559, at *14.

[15] 2017 WL 2774559, at *17.

[16] 2017 WL 2774559, at *18.

[17] Allen, 72 A.3d at 107.

[18] 2017 WL 2774559, at *14

[19] See Gerber v. Enter. Prod. Holdings LLC, 67 A.3d 400, 418 (Del. 2013) overruled on other grounds by Winshall v. Viacom Int'l Inc., 76 A.3d 808 (Del. 2013)(“insofar as Section 7.10(b) creates a conclusive presumption of good faith, that provision does not bar a claim under the implied covenant.”)

[20] 2017 WL 2774559, at *13

[21] Nemec v. Shrader, 991 A.2d 1120, 1126 (Del. 2010).

[22] Robert Schwartz, Delaware as a Location for Private Funds: The Why and the What, Bloomberg BNA World Securities Law Report Vol. 18, No. 8, p. 6 (2012).