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Taking a closer look at MLPs

STEPS A COMPANY OR BOARD SHOULD TAKE WHEN EXAMINING CONFLICT TRANSACTIONS

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IN RECENT YEARS, many US energy firms have reorganized their slow-growing, yet stable businesses, such as pipelines and storage terminals, into master limited partnerships, or MLPs. Whereas 20 years ago, there were only a handful of MLPs, there are now over 130, with an average of 8 to10 new IPOs per year. Transactions between MLPs and their general partners (drop-downs) are highly prevalent in the sector, with an average of 40 transactions per year in 2012, 2013, and YTD 2014.

This article will examine and provide sample cases of the steps a company or board of directors should undergo when examining conflict transactions in the MLP sector. Specific areas covered include:

- Board of directors' duties with regards to conflict transactions and whether these standards differ for MLPs versus corporations;
- If the subjective standard excuses the board or conflict committee from looking at objective analysis;
- What a special committee or conflicts committee of an MLP should do first to ensure that their approval will withstand scrutiny or challenge;
- Once a potential conflict transaction is identified, what steps need to be taken; and
- Finally, best practices for identifying a financial planner/fairness opinion provider.

IN GENERAL, WHAT ARE THE BOARD MEMBERS' DUTIES WITH REGARDS TO CONFLICT TRANSACTIONS?

Legal responsibilities of board members have evolved over the years from application of decisions by courts into a doctrine commonly referred to as the Business Judgment Rule. The basic premise is that executives and directors are not liable for decisions that are made in good faith. The hallmarks of the business judgment rule are acting independently, in good faith, on an informed basis (due care) with the honest belief that a transaction is in the best interest of the company.

In 1983, a new concept in the context of board responsibilities with regards to conflict transactions emerged with the Delaware Supreme Court's decision in Weinberger v. UOP, Inc. In that case, although the board had obtained a fairness opinion regarding a transaction that squeezed out equity ownership of many minority shareholders, the court was critical of the haste in which the fairness opinion was prepared and the lack of independence of the opinion's issuer, an investment bank that also received significant fees from the transaction. In this case, the Delaware Court introduced the concept of ***Entire Fairness,*** which encompasses both ***fair dealing*** (how the transaction is structured, where and how it is initiated, how it was disclosed and negotiated with the directors, and what and how approvals were received) and ***fair price*** (economic and financial considerations). All aspects of a transaction must be viewed as a whole to evaluate Entire Fairness.

In 1985, the Delaware Supreme Court, in Smith v. Van Gorkom, opened the door to third-party fairness opinions, providing a safe haven for satisfaction of the business judgment rule. In that case the court criticized the directors of Trans Union Corporation as grossly negligent for relying on Chairman Van Gorkom's valuation of a leveraged buyout transaction. The court specifically stated that the directors could have mitigated this negligence by obtaining a fairness opinion. That decision played a large role in the proliferation of fairness opinions in potential conflict transactions.

DO THESE STANDARDS DIFFER FOR MLPS VERSUS CORPORATIONS?

Yes. Under the Delaware Limited Partnership Act, as limited partnerships, MLPs are given greater leeway than corporations to define contractually in their partnership agreements the standards for evaluating potential conflict transactions. This act enables MLPs to expressly eliminate all common law fiduciary duties (except good faith and fair dealing). MLP limited partnership agreements are explicit about how conflicts of interest are to be resolved. Typically it involves one of the following four courses of action:

1. Special Approval – the majority of the members of the conflicts committee acting in good faith;
2. Affirmative vote of a majority of outstanding common units (excluding those owned by GP and affiliates);
3. On terms no less favorable to the partnership than those available from unrelated third parties (Entire Fairness); and
4. Fair and reasonable to the partnership.

Most MLP conflict transactions are approved using the "Special Approval" clause. Recent court cases (Gerber v. EPE Holdings – Del 2013, Allen v. Encore Energy partners – Del 2013, Allen v. El Paso Pipeline GP – Del 2014) have focused on the application of good faith via Objective versus subjective beliefs that the action taken is in the best interests of the partnership. In each case the court held that the subjective standard was enough. However, following Gerber, MLP partnership agreements have been drafted to explicitly state that a subjective standard will apply.

DOES THE SUBJECTIVE STANDARD EXCUSE THE BOARD OR CONFLICT COMMITTEE FROM LOOKING AT OBJECTIVE ANALYSIS?

In the case mentioned above, the Delaware Court also pointed out that objective facts remain logically and legally relevant to the extent they permit an inference that a defendant lacked the necessary subjective belief. In other words, the extensive review of objective analysis provides support for the subjective conclusion.

WHAT SHOULD A SPECIAL COMMITTEE OR CONFLICTS COMMITTEE OF AN MLP DO FIRST TO ENSURE THAT THEIR APPROVAL WILL WITHSTAND SCRUTINY OR CHALLENGE?

Even though, as described above, a MLP's obligations with regards to approving conflict transactions are contractually defined, there are many best practices that can be followed to minimize the chance or success of a legal challenge. The first is the formation of a standing conflicts or special committee. Most MLPs have already formed these independent committees or have empowered a subset of the Audit Committee to address fairness of potentially conflicting transactions. It is important that members of this special committee be independent not only from the traditional NYSE or NASDAQ standards but also from ownership (especially GP), material financial ties to MLP sponsors and/or former business relationships.

It is also important that the special committee is empowered to act independently, negotiate with management and ultimately to "say no" if they do not subjectively believe a transaction is fair.

ONCE A POTENTIAL CONFLICT TRANSACTION IS IDENTIFIED WHAT STEPS NEED TO BE TAKEN?

Typically, the first step a special committee takes in the context of a conflict transaction is to hire its own legal and financial advisors. Usually the legal advisors are hired first so that they can advise on the process of interviewing advisors and negotiating the accompanying engagement letter. For both the legal and financial advisors, it is important that the special committee not simply use a firm suggested by management but rather interview and select advisors of their choosing.

WHAT SHOULD A SPECIAL COMMITTEE LOOK FOR IN A FINANCIAL PROVIDER / FAIRNESS OPINION PROVIDER?

The number one thing to look for is independence. Many of the court cases that have been adverse to boards have criticized the financial advisor's objectivity. While not exhaustive, several "best practices" to ensure independence include:

- Interview three or more firms that are not involved in the transaction under consideration;
- Do not use a firm that earned or hopes to earn meaningful fees from the MLP (capital markets providers, M&A advisors, lenders etc.);
- Do not use the fairness engagement to "pay back" firms for other services; and
- Make sure the fairness opinion fee is not contingent on the closing of the transaction.

In addition to independence, the courts have been increasingly critical of the qualifications of the firm providing the opinion. In Tousa (2012), the court criticized the opinion provider for a lack of industry expertise. Especially in the MLP sector, finding a firm who is experienced with the complexities of the structure (GP vs LP, Sub Units, IDRs, etc.) is critically important. Structural considerations play an important role in the evaluation of considerations for different partnership classes.

Qualifications should also include being a nationally recognized fairness opinion provider. While many firms provide fairness opinions, many view the practice as an "add-on" to other higher-fee businesses like M&A. A fairness opinion provider who has experience and expertise not only provides the opinion (fair price) but can also act as a guide to the committee with regards to process best practices (fair dealing).

SPEAKING OF BEST PROCESS PRACTICES, WHAT SHOULD A SPECIAL COMMITTEE FOCUS ON IN THE CONTEXT OF A DROPDOWN TRANSACTION?

In general, time is a very important factor when establishing the due care with which the committee evaluates the transaction. As noted previously, a key criticism of the court in Weinberger was the cursory and rushed timetable (over the weekend). There always seems to be a conflicting dynamic at play - with company management usually looking for a fast approval. This is further emphasized in publicly traded entities where leaks of nonpublic information are a concern.

A comfortable timetable to evaluate a transaction is three to four weeks. However, often times, the schedule is compressed significantly. A shorter timeframe can often be supported especially in cases where the advisor has an in depth knowledge of the company and industry. Well-documented committee meetings are important. There should be multiple meetings (in-person is better but often telephonic has to suffice) with the financial advisors so that committee members have a chance to digest material and ask questions. An approval vote should never take place during the same meeting in which the transaction is proposed by management or the sponsor.

In terms of due diligence, a special committee and its advisor must rely to a large degree on information provided by the sponsor or management. This is okay, assuming that both the advisor and committee satisfy themselves through an appropriate level of due diligence. Success in this regard requires an open and responsive line of communication with management. Committee members and their advisors should not be shy about requests on specific issues and questions. Minutes should reflect the scope and depth of due diligence.

IS IT NECESSARY FOR A SPECIAL COMMITTEE TO NEGOTIATE THE TERMS OF THE TRANSACTION?

Yes and no. Certainly a special committee must be empowered to negotiate with management and to the extent that they can be involved in that process, the earlier the better. That being said, one must be cognizant that the objective isn't to create an adversarial environment simply for its own sake. For example, companies might ask if they should purposefully propose a transaction with a higher price than they expect so that the special committee has room to "negotiate." This is not recommended for several reasons. Operating in the spirit of open and honest dialogue is more conducive to a better exchange of information, and while negotiating for a more favorable price or terms is certainly a good fact pattern, it still must be based on objective analysis. The committee that is truly empowered to negotiate a transaction is, in practice, usually more evident by the process than by the price.

IS THERE ANYTHING SPECIAL ABOUT ANALYSIS PROVIDED AS PART OF A FAIRNESS OPINION?

The analysis itself should be consistent with best practices for a particular industry. In regard to MLPs, looking at the effects of IDRs and subunits can be very important. One thing that advisors and committees should also be aware of is the increasing scrutiny that courts are giving to changes in analysis provided to the board. In re: Occam Networks (Del Ch. 2011), the court was critical of the comparison between the final board presentation and earlier versions given to the board. In Rural Metro Corporation Stockholders Litigation (Del. 2014), the court continued to be critical of the "time-series" analysis of board books, but went even further to criticize the financial advisor by comparing their initial pitch-book to the final board-book. The court implied that the differences suggested "manipulation" of the analysis used for the fairness opinion. It is critical that the reasons for changes in assumptions or analysis be thoroughly justified and documented.

In addition to "time-series" differences in analysis, another potential area for concern is misinterpretation of sensitivity analysis. If "sensitivity" or "stress" cases are used, especially in board-books, it is important they be explicitly clear about the expectations regarding the cases' expected probability or expected likelihood vs. the "base" case. Certainly, sensitivity analysis can play a valuable role in evaluating a transaction, but only if it is clear and can be understood as a standalone document in the context of litigation.

HOW FAR BEFORE THE APPROVAL OF THE TRANSACTION SHOULD THE FAIRNESS OPINION BE DELIVERED?

While it may seem counter-intuitive to the discussion above, a fairness opinion should be provided right before the committee votes to approve the transaction. This is to protect the committee against material market movements that could have an impact on the opinion conclusion. That being said, it is important for the committee to receive at least a draft of the analysis far enough in advance that they can digest the information and ask questions as appropriate. They need to be 100% comfortable with the analysis before receiving the formal "opinion" and voting on the transaction.

WHAT ABOUT CASES WHERE THE MARKET MOVES IN THE TIME BETWEEN APPROVING THE TRANSACTION AND CLOSING?

Several court cases have addressed the need for or requirement of updates to the analysis and/or opinion. In HA 2003 Liquidating Trust v. Credit Suisse (7th Cir 2008) the court found that the financial advisor was not grossly negligent in failing to update or withdraw its opinion. However, in re: Southern Peru Copper (Del. Ch 2011), the court criticized the special committee for failing to revisit its recommendation following a significant movement in the price of Southern Peru's shares (transaction had a fixed exchange ratio). These potentially conflicting decisions emphasize the need to be very explicit in the engagement letter about when and why an update would occur. Advisors need to be proactive in making sure special committees understand how changes in external factors can subsequently affect value. OGFJ

ABOUT THE AUTHOR

James Hanson is a managing director specializing in transaction opinions, M&A, and private capital raising for companies in the energy sector. He has over 20 years of energy investment banking experience with 18 focused primarily on MLPs. His experience includes corporate finance and advisory transactions including public and private equity and debt financings as well as buy- and sell-side M&A transactions. He has worked across all major energy sectors. Prior to joining Duff & Phelps, Hanson was a managing director, partner and head of energy banking at M. M. Dillon & Co. Before that, he led the energy practice at Houlihan Lokey. Hanson spent the majority of his career at investment banks including Citigroup (previously Salomon Brothers), Bear Stearns, and Barclays Capital. During that time he advised a wide variety of large cap and mid cap energy companies in M&A and public capital markets transactions, raising over $25 billion for his clients. He holds an MBA degree in finance from The Wharton School, University of Pennsylvania, and a BS in finance from the University of Illinois in Champaign-Urbana. He received the chartered financial analyst (CFA) designation and is a FINRA Series 7 and 79 registered representative.

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