

Partnership Agreement Did Not Eliminate Implied Covenant of Good Faith and Fair Dealing

On June 10, 2013, the Delaware Supreme Court issued an opinion in *Gerber v. Enterprise Products Holdings, LLC* (“*Gerber*”),¹ clarifying the degree to which parties to a partnership agreement may contract out of their fiduciary duties. Delaware law allows general partners to modify or eliminate their fiduciary duties by contract so long as the implied covenant of good faith and fair dealing remains intact.² In *Gerber*, the Court held that the lower court erred in dismissing a claim for breach of the implied covenant on the grounds that the claim was foreclosed by the express terms of the partnership agreement.

I. Factual Background³

Enterprise GP Holdings, LP, (“EPE”) was a limited partnership tied into a complex partnership structure with Enterprise Products, L.P. (“Enterprise Products LP”) and Enterprise Products Holdings, LLC (“Enterprise Products GP”). In May 2007, EPE bought Texas Eastern Products Pipeline Company, LLC (“Teppco”) for \$1.1 billion worth of EPE limited partnership units. Two years later, EPE sold Teppco to Enterprise Products LP for approximately \$100 million (“the 2009 Sale”). The sale was first approved by the Audit, Conflict and Governance Committee (“ACG Committee”) of Enterprise Products GP – the general partner of EPE – and later by the board of Enterprise Products GP itself. As part of the approval process, Morgan Stanley delivered an opinion to the ACG Committee finding that the total consideration paid for Teppco and a Teppco affiliate sold in a separate transaction was fair in the aggregate. The opinion only addressed the combined transactions and did not assess the fairness of the consideration specifically paid in the 2009 Sale.

In July 2010, Enterprise Products LP and Enterprise Products GP started negotiating a merger between EPE and Enterprise Products LP (“the 2010 Merger”). According to the Court of Chancery, the primary purpose of the proposed merger was to extinguish unliquidated legal claims held by the EPE partnership unit holders. These included a pending derivative suit challenging the fairness of the \$1.1 billion paid for Teppco in 2007, and any claims that could later arise in connection with the sale of Teppco in 2009 for 9% of the original purchase price. Enterprise Products GP ultimately accepted an offer from Enterprise Products LP to convert each outstanding partnership unit in EPE into 1.5 partnership units of Enterprise Products LP. Prior to acceptance, Enterprise Products GP consulted Morgan Stanley for an opinion on the fairness of this exchange ratio. Morgan Stanley stated that the ratio was fair, but did not factor the value of EPE’s legal claims into its analysis. Thus, Enterprise Products GP never considered the claims in deciding whether Enterprise Products GP’s offer was fair to the partnership unit holders of EPE.

II. Procedural History

In March 2011, Joel Gerber, a former owner of partnership units in EPE, brought an action against Enterprise Products GP, Enterprise Products LP, the board of Enterprise Products GP, and the estate of Dan Duncan, who had previously controlled all three companies. Gerber alleged, among other things, that the defendants breached their contractual duties under EPE’s Limited Partnership Agreement (“LPA”) and the implied covenant of good faith and fair dealing in carrying out the 2009 Sale and 2010 Merger. Gerber claimed

¹ *Gerber v. Enterprise Products Holdings, LLC*, No. 46, 2012 (Del. June 10, 2013) available at <http://courts.delaware.gov/opinions/download.aspx?ID=190370> (the “Opinion”).

² 6 *Del. C.* § 17-1101(d).

³ The factual background is summarized from the facts set forth in the Court’s opinion.

that the consideration received in the 2009 Sale was grossly inadequate, and that the 2010 Merger unfairly deprived EPE partnership unit holders of compensation for their legal claims.

The Delaware Court of Chancery dismissed Gerber’s complaint after determining that the provisions of the LPA insulated the defendants from liability.⁴ The LPA modified fiduciary duties in accordance with 6 *Del. C.* § 17-1101, and provided that Enterprise Products GP and its affiliates would only be subject to a contractual duty of “good faith,” defined as a belief “that the determination or action was in the best interests of the Partnership.”⁵ Two additional LPA provisions limited judicial review into whether the conduct of Enterprise Products GP or its affiliates satisfied the contractual fiduciary duties. First, the LPA stated that transactions involving a conflict of interest between EPE and Enterprise Products GP could not give rise to claims for a breach of fiduciary duties if the transactions received “Special Approval” by a majority of members of the ACG Committee.⁶ Second, the LPA provided that a “conclusive presumption” of good faith would arise if, in taking a course of action, Enterprise Products GP consulted with investment bankers and acted in reliance on their opinion.⁷

Because both the 2009 Sale and 2010 Merger received “Special Approval” by the ACG Committee, the Chancery Court held that the claims for breach of the contractual duty of good faith were barred by the LPA provisions.⁸ Moreover, the ACG Committee’s reliance on Morgan Stanley’s fairness opinion in approving the 2009 Sale and 2010 Merger gave rise to a “conclusive presumption” under the LPA that the duty of good faith was discharged, which automatically foreclosed any claim under the implied covenant of good faith and fair dealing.⁹

III. The Decision of the Delaware Supreme Court

On appeal, Gerber asserted, among other things, that the Court of Chancery erred in deciding that the LPA’s “conclusive presumption” provision barred his claim for breach of the implied covenant.¹⁰ The Court agreed, and found that the complaint adequately pled that Enterprise Products GP breached the implied covenant with the 2009 Sale and 2010 Merger.¹¹ The Court of Chancery’s judgment of dismissal of the implied covenant claims was reversed, and the case remanded for further proceedings.¹²

The Delaware Supreme Court found that the Court of Chancery improperly ignored important distinctions between the LPA’s contractual duty of good faith and the implied covenant of good faith and fair dealing.¹³ The Court adopted the analysis of these differences as articulated in *ASB Allegiance Real Estate Fund v. Scion Breckenridge Managing Member, LLC*.¹⁴ As explained in *ASB Allegiance*, courts deciding implied covenant

⁵ Opinion at 15.

⁶ *Id.* at 15-16.

⁷ *Id.* at 16-17.

⁸ *Id.* at 19, 23.

⁹ *Id.* at 22-23.

¹⁰ *Id.* at 25.

¹¹ *Id.* at 28.

¹² *Id.* at 29.

¹³ *Id.* at 35.

¹⁴ *Id.* at 32-34 (quoting *ASB Allegiance Real Estate Fund v. Scion Breckenridge Managing Member, LLC*, 50 A.3d 434, 440-442 (Del. Ch. 2012), *aff’d in part, rev’d in part on other grounds*, 2013 WL 1914714 (Del. May 9, 2012)).

claims ask whether it is clear from the terms of an agreement that the parties would have prohibited certain conduct if they had thought to address it at the time of contracting.¹⁵ In a fiduciary duty analysis, by contrast, courts look to the parties at the time of the alleged wrong and ask if a duty was violated.¹⁶ Emphasizing these temporal differences, the Court held that the LPA’s “conclusive presumption of good faith” did not “operate retroactively to alter the parties’ reasonable expectations at the time of contracting.”¹⁷ The presumption bars claims asserting a violation of the contractual duty of good faith, but does not apply to claims based on a breach of the implied covenant of good faith and fair dealing.¹⁸ Thus, the lower court erred in holding that Gerber’s implied covenant claim was foreclosed by the LPA provisions.¹⁹

The Court then found that Gerber’s complaint pled sufficient facts to establish that Enterprise Products GP breached the implied covenant in carrying out the 2009 Sale and 2010 Merger. Establishing a breach of the implied covenant requires showing that Enterprise Products GP “acted arbitrarily or unreasonably, thereby frustrating the fruits of the bargain that [Gerber] reasonably expected.”²⁰ With respect to the 2009 Sale, the complaint alleged that the transaction was blatantly unfair, and that the Morgan Stanley opinion used to activate the LPA’s “conclusive presumption of good faith” did not specifically address the fairness of the consideration paid for Teppco.²¹ The Court held that if this issue had been addressed at the time of contracting, the parties would have decided that the fairness opinion needed to assess the adequacy of the consideration paid in the 2009 Sale, not the fairness of two combined transactions.²² The Court also held that Gerber sufficiently pled a breach of the implied covenant in connection with the 2010 Merger, since Gerber could not reasonably have anticipated that Enterprise Products GP would pursue an EPE merger in order to invalidate EPE’s derivative claims while using a fairness opinion that did not take the value of those claims in account.²³

The Court noted that although Gerber pled a breach of the implied covenant, there could be no breach of the LPA if Enterprise Products GP received protection for obtaining “Special Approval” of the 2009 Sale and 2010 Merger.²⁴ The Court found, however, that the complaint adequately pled that Enterprise Products GP breached the implied covenant in pursuing “Special Approval,” so the LPA afforded no protection.

With respect to the 2009 Sale, the Court’s finding was based on the Court of Chancery’s holding that, if the LPA had not barred the claim, the complaint would have adequately alleged that Enterprise Products GP breached the implied covenant in using the “Special Approval” process.²⁵ The defendants did not cross-appeal this holding, so it became the law of the case.²⁶ The Court also independently reviewed the complaint and confirmed that it alleged a violation of the implied covenant.²⁷

¹⁵ *Id.* at 33.

¹⁶ *Id.*

¹⁷ *Id.* at 36.

¹⁸ *Id.* at 35-36.

¹⁹ *Id.* at 37.

²⁰ *Id.* at 38 (quoting *Nemec v. Shrader*, 991 A.2d 1120, 1125 (Del. 2010)).

²¹ *Id.* at 38.

²² *Id.* at 40.

²³ *Id.* at 41.

²⁴ *Id.* at 41.

²⁵ *Id.* at 43.

²⁶ *Id.* (citing *Scharf v. Edgcomb Corp.*, 864 A.2d 909, 914 (Del. 2004)).

²⁷ *Id.* at 44.

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As to the 2010 Merger, the Court did not discuss the “Special Approval” process, but concluded that Gerber had a reasonable expectation that he would be compensated for his unliquidated legal claims in the merger, and the complaint alleged a legally sufficient claim for breach of the implied covenant.²⁸ Consequently, the Court of Chancery reversibly erred and the case was remanded for further proceedings.

The implied covenant of good faith and fair dealing is alive and well in Delaware.

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If you have any questions about the issues addressed in this memorandum or if you would like a copy of any of the materials mentioned, please do not hesitate to call or email Charles A. Gilman at 212.701.3403 or cgilman@cahill.com; Jon Mark at 212.701.3100 or jmark@cahill.com; John Schuster at 212.701.3323 or jschuster@cahill.com.

²⁸ *Id.* at 45-47.