Sponsors of yieldcos, master limited partnerships ("MLPs") and other spin-offs are well aware that courts may second-guess related party transactions, and as a result have developed procedures to address potential conflicts of interest. In a recent decision, In re: El Paso Pipeline Partners, L.P. Derivative Litigation, the Delaware Court of Chancery underscored the need to ensure that those procedures are not mere formalities – they must produce a substantive inquiry into the merits of related party transactions. In finding an affiliate of El Paso Corporation liable for $171 million for overpaying for an LNG terminal and natural gas pipeline, Vice Chancellor Laster strongly criticized the conflicts committee of an MLP, as well as its advisors, for showing “conscious indifference to their responsibilities” to assess whether the transaction was in the best interest of the MLP. A copy of the court’s opinion can be found here.

The El Paso Pipeline decision has immediate, international repercussions. Given the large damage award and the roadmap it provides, El Paso Pipeline is likely to embolden plaintiffs’ lawyers to challenge other such transactions. Those challenges may be launched in any country where a yieldco, MLP or similar vehicle or its general partner is established.

In light of the decision and the increased scrutiny it may provoke, those undertaking related party transactions should revisit their procedures to ensure that, at minimum, a conflicts committee’s decision is demonstrably independent, well-reasoned and documented.

Background of the Case

El Paso Corporation (the “Sponsor”), an energy provider, established an MLP, El Paso Pipeline Partners, L.P. (“El Paso MLP”), which issued common units that traded on the New York Stock Exchange. The Sponsor retained a majority economic interest in, as well as preferential incentive distribution rights with respect to, and de jure control of, El Paso MLP. Investors expected, and received, dividends representing cash flow from the pipelines contributed to El Paso MLP.

As is typical for such structures, it was expected that from time to time, El Paso MLP would purchase interests in additional assets from the Sponsor in
“dropdown” transactions to achieve growth in the dividend. To ensure that these related party transactions took place on terms no less favorable to El Paso MLP than would be obtained in an arms-length transaction, El Paso MLP’s partnership agreement (the “LP Agreement”) required that an independent conflicts committee of the Board of Directors of the general partner of El Paso MLP (the “Conflicts Committee”) be established to review related party transactions and determine whether such transactions were in the best interests of El Paso MLP. These contractual requirements replaced any common law duties, including fiduciary duties, that the Conflicts Committee would have otherwise owed to El Paso MLP, but which were waived by the LP Agreement.

The court’s decision related to a 2010 dropdown transaction that was proposed by the Sponsor and submitted to the Conflicts Committee, which consisted of three directors. Although all three satisfied the independence criteria of the U.S. Securities and Exchange Commission, the court noted that two of them had extensive past ties to the Sponsor. The Chairman of the Conflicts Committee had served as Chairman of the Sponsor for nine years and owned roughly twice as much equity of the Sponsor as of El Paso MLP. A second member’s career had been closely intertwined with the Chairman’s, and he had served for 10 years as a senior executive of a company eventually acquired by the Sponsor, and three years after the acquisition as an executive of the Sponsor. He owned roughly equal amounts of equity in the Sponsor and in El Paso MLP.

The Conflicts Committee retained outside counsel and a financial advisor, as it had in prior dropdown transactions, and authorized its Chairman to negotiate the transaction at issue, which involved purchases of interests in LNG and natural gas pipeline companies owned by the Sponsor (the “Dropdown Assets”). After consultation with its outside advisors, negotiation by the Chairman of the Conflicts Committee with the Sponsor and moderate improvement in the terms of the transaction from the Sponsor’s original offer, the Conflicts Committee approved the transaction. (The facts and process, as well as a discussion of other related transactions between the entities, are described in detail in the court’s opinion.)

The market price of units of El Paso MLP declined in reaction to the announcement of the dropdown transaction, and soon thereafter unitholders of El Paso MLP brought suit against the Sponsor, the general partner of El Paso MLP and their affiliates, claiming that El Paso MLP overpaid for the Dropdown Assets. Although these sales were referred to, and ultimately approved by, the Conflicts Committee, the court performed an in-depth review of the Conflicts Committee’s process and analysis. The applicable standard for review was specified in the LP Agreement, which required only that the members of the Conflicts Committee believe in good faith that the transaction was in the best interests of El Paso MLP. The court found that despite the Conflicts Committee’s approval of the transaction, its members did not in fact subjectively believe that El Paso MLP’s purchase of the Sponsor’s gas subsidiaries was in El Paso MLP’s best interests.
Because the standard was not met, the court held that the General Partner of El Paso MLP had breached the LP Agreement.

Among other things, the court found:

- that e-mails between the Conflicts Committee members evidenced a belief that the transaction was not in the best interest of El Paso MLP, and suggested that the members of the Conflicts Committee did not act independently but rather subordinated their views to achieve the Sponsor’s objectives;

- that the Conflicts Committee judged the transaction by the wrong standard, focusing on whether it was accretive (that is, whether it would increase distributions to unitholders) rather than whether it was in the best interest of El Paso MLP, as determined by the price paid in relation to the fair market value of the dropdown assets; and

- that the financial advisors, who would be paid on a wholly contingent basis, were motivated to ensure the transaction closed and used a results-oriented process designed not to fully inform the Conflicts Committee, but to justify the Sponsor’s asking price.

Although none of these issues would have sufficed independently to undermine the transaction, the court found that “the number of problems reached a tipping point” where it became apparent that the Conflicts Committee members simply “went through the motions” in discharging their duties.

The court awarded $171 million in damages, which represented the difference between the price paid for the Dropdown Assets and their value as calculated by the plaintiffs’ expert.

Implications

As the El Paso Pipeline decision illustrates, sponsors must take measures to ensure that related party transactions will pass judicial scrutiny. That means putting an appropriate governance framework in place, being aware of the standard by which the members of the conflicts committee must judge a transaction, having the benefit of impartial external advice, and fully examining all relevant considerations. In addition, the decision suggests that:

- Any financial advisor should operate independently and be held accountable to the conflicts committee. The financial advisor’s view should be supported by reports and presentations that are comprehensive, objective and in line with industry standards. In addition, committees should consider retaining financial advisors on a flat-fee basis, rather than a contingency fee basis, which a court could interpret as hindering objectivity.
• Technical satisfaction of regulatory criteria regarding director independence may not be sufficient under a court’s retrospective gaze. Committee members should not have connections to the sponsor that might be perceived as jeopardizing their ability to assess impartially the fairness of a related party transaction.

• The conflicts committee should establish a comprehensive contemporary record, which could include meeting agendas, tabled papers, official minutes and reports. Conflicts committee members should be reminded that a court may review anything they write in relation to a transaction, including emails between committee members. Similarly, executives at all levels – whether with the sponsor, a yieldco or MLP – should be aware that their emails and other forms of communication may also be subject to court review.

These lessons will apply equally no matter what law applies to judge the actions of the members of a conflicts committee. We set forth below some considerations relating to yieldcos or MLPs established in Spain or in the UK.

Spain

The Spanish Companies Act imposes on directors of Spanish companies a duty to act “in the best interests of the company,” which implies that they must both subjectively believe that the transaction under scrutiny advances the common interest of the shareholders and that the transaction also objectively increases the long-term value of the company.

Additionally, Spanish law includes procedural rules to deal with related party transactions that cannot be waived. In practice, either the conflicted transaction is approved through a fair procedure (i.e., the decision is taken by non-conflicted directors through a transparent procedure in which complete information on the transaction is provided to the directors, who judge whether the transaction embodies fair economic terms equivalent to those of an arm’s length transaction) or the burden lies with the conflicted partner or director to prove that the transaction is in the best interest of the company (i.e., an entire fairness test is undertaken by the courts).

Spanish companies that regularly engage in related party transactions should consider the potential indirect impact of the El Paso Pipeline case and confirm that their procedures and governance mechanisms are adequate to withstand scrutiny in hindsight.

United Kingdom

The position on conflicts of interest under English law is similar to that outlined above. In particular, English law provides that the directors of an English company owe certain duties to that company (and if the company is listed in the
UK, certain additional rules and duties may apply). These duties include the following:

- A duty to promote the success of the company: a director must act in the way he considers, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole.

- A duty to avoid conflicts of interest: a director of a company must avoid a situation in which he has, or can have, a direct or indirect interest that conflicts, or possibly may conflict, with the interests of the company.

Therefore, if a particular decision is in the best interests of a yieldco, the directors must support that decision even if it is contrary to the interests of its sponsor. Similarly, given that the interests of the yieldco will not necessarily be the same as the interests of its sponsor's group, any action approved by the yieldco directors in the interests of the sponsor group must also be in the interest of the yieldco.

Furthermore, the directors must comply with their statutory obligations to avoid conflicts of interest and breaches of related fiduciary duties. They will therefore need to consider whether it is appropriate for them to participate in a particular board meeting and whether they may be conflicted, notwithstanding any board authorization. For example, it may be advisable for the non-independent directors to absent themselves from board meetings at which a related party transaction is being approved and not to vote at, or receive the board papers relating to, that meeting. In the yieldco context, where significant related party transactions are frequent, formation of a committee of independent directors for this purpose may be advisable. Alternatively, a director may be able to declare to the other directors any interest he has directly or indirectly in a proposed transaction with the company in order to avoid the consequences of a conflict of interest or the need for an independent committee. However, we suggest it is better for directors to avoid if possible conflicts arising at all and/or absent themselves from the decision-making. If it is feasible in the circumstances (such as on infrequent, major transactions) shareholder ratification may be a further option where there is a risk of a conflict arising. Facts such as those that gave rise to damages in *El Paso Pipeline* would be likely to be viewed similarly by an English court. At meetings at which related party transactions are being considered, the independent directors (or committee) would be required to vote on the relevant transaction. In these circumstances, there would be no legal requirement under English law for them to receive any additional advice or information (for example, from separate experts or counsel) but, as the *El Paso Pipeline* decision
Illustrates, they may want to obtain such advice in order to ensure that they can comply with their own statutory duties.

English companies that regularly engage in related party transactions should consider the potential indirect impact of the *El Paso Pipeline* case and confirm that their procedures and governance mechanisms are adequate to withstand scrutiny in hindsight.

**Conclusion**

The *El Paso Pipeline* decision may be appealed – and indeed, it is already being collaterally challenged on procedural standing grounds – but because it is heavily based on factual findings, including determinations of credibility (as to which appellate courts typically defer to the trial judge), obtaining reversal may be difficult. Assuming that it is not reversed, and in any event pending any appeal, the decision is likely to embolden plaintiffs' lawyers to challenge other such transactions. Based on past experience with other companies, any related party transaction that results in a drop in the price of a yieldco’s listed securities can be expected to lead to litigation.

We therefore urge yieldcos, MLPs and their general partners to review their procedures for evaluating dropdowns. We are of course available to assist and advise in any such review. Please do not hesitate to contact your Linklaters contacts to discuss any of these issues. Although the standard applicable to director conduct will vary from country to country, in general yieldcos, MLPs and other spin-offs should ensure that their review is independent, well-reasoned and documented.