DELAWARE BUSINESS COURT INSIDER

December 17, 2014 An ALM Website

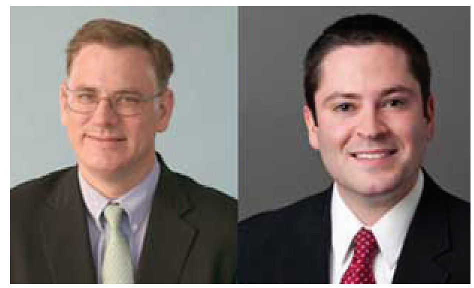
A Reminder to Focus on Form in Assessing Limits of Business Entities

By James L. Hallowell and Brian R. Morgenstern,
Delaware Business Court Insider

On Nov. 5, Delaware Court of Chancery Vice Chancellor J. Travis Laster issued a decision in *In re Kinder Morgan Corporate Reorganization Litigation*, C.A. No. 10093-VCL (Del. Ch. 2014), that reminds practitioners that attention to the technical requirements of relevant business entities remains a key tenet of Delaware practice. Moreover, while the Chancery Court is famous as the hub of substantive fiduciary analysis, particularly for shareholder suits involving large, publicly traded C corporations, the court retains its traditional focus on the formal boundaries arising from the Delaware statutes, including those regarding alternative business entities.

The decision arises from an effort by Kinder Morgan Inc. to simplify its admittedly complex organizational structure. The specific transaction at issue, one of several undertaken in tandem by Kinder Morgan, was an agreement and plan of merger that called for Kinder Morgan Energy Partners, a Delaware limited partnership with publicly traded units, to merge with a wholly owned subsidiary of Kinder Morgan, which controls KMEP through sole ownership of its general partner and a substantial interest in KMEP's limited partner units. After the merger, KMEP would remain the surviving legal entity and a wholly owned subsidiary of Kinder Morgan. Limited partner units in KMEP would be converted into the right to receive, at the election of the holder, cash, shares of Kinder Morgan common stock, or a mix of cash and stock.

The defendant merger parties contended that, pursuant to the terms of the KMEP partnership agreement, the merger needed the approval only from holders of a majority of KMEP's three classes of limited partnership units (common units, Class B units and I-units), voting together as a single class. The plaintiffs, holders of common units, contended the merger should be evaluated as though it were to be effected through an amendment to the KMEP partnership agreement (not through a merger), and that approvals were therefore required from: the holders of two-thirds of KMEP's three classes of limited partnership units, voting as a single class; the holders of two-thirds of KMEP's common units; and the holders of 95 percent of KMEP's limited partnership units, unless the



James L. Hallowell and Brian R. Morgenstern

partnership obtained an opinion from counsel confirming that it would continue to be taxed as a pass-through entity. Although the plaintiffs also contended in the litigation that the terms of the proposed merger were unfair, their preliminary injunction motion, seeking to enjoin the merger, focused only on their voting-rights theory.

Laster denied the plaintiffs' motion, noting the plaintiffs did not have a reasonable probability of success on the merits. The KMEP partnership agreement provides for approval of mergers, including mergers between the partnership and any type of business entity (including an LLC) by a simple majority of the outstanding limited partner units voting as a single class. Amendments require a higher threshold for approval: two-thirds of the limited partner units, two-thirds of the affected units—here, the publicly traded common units—and either 95 percent approval of the limited partner units or an opinion of counsel that the partnership will continue to be taxed as a pass-through entity after the merger. Critically for the parties' dispute, the KMEP partnership agreement also contains what Laster termed an "amendment-by-merger exception," requiring that the higher voting threshold necessary for a partnership agreement amendment will control in circumstances where the parties effectuate an amendment to the partnership agreement through the device of a merger.

In denying the plaintiffs' motion for a preliminary injunction, the court held that the "amendment-by-merger exception" did not apply to the proposed merger. The court noted KMEP will remain as the surviving business entity after the merger, with the same (unamended) partnership agreement. Thus, the merger does not, in fact, involve an amendment to the partnership agreement.

Kinder Morgan serves to remind practitioners of a key, fundamental lesson: address first principles and move on to further arguments only if first principles don't resolve the issue. The Chancery Court is the go-to authority on issues involving shareholder activism, proxy wars and derivative suits, many of which hinge firmly on whether directors have breached their fiduciary duties to shareholders. However, litigants should not ignore the formal lines drawn in an entity's foundational document—in this case, KMEP's governing partnership agreement—before jumping ahead to arguments regarding fiduciary obligations.

As Laster notes, quoting former Chancellor William T. Allen: "'The entire field of [business entity] law has largely to do with formality. [Business entities] come into existence and are accorded their characteristics, including most importantly limited liability, because of formal acts. Formality has significant utility for business planners and investors. While the essential fiduciary analysis component of [business entity] law is not formal but substantive, the utility offered by formality in the analysis of our statutes has been a central feature of Delaware [business entity] law.'"

In the *Kinder Morgan* dispute, rather than focus on whether the proposed merger agreement sought explicitly through its terms to implement an amendment to the KMEP partnership agreement, the plaintiffs sought a different inquiry. A higher threshold for merger approval should be required, they contended, if a result substantively similar to that affected by the merger could possibly be accomplished through an amendment to the governing partnership agreement.

Laster declined to accept the analysis suggested by the plaintiffs. In his view, the plaintiffs' proposed "open-ended inquiry into substantively equivalent outcomes" would drift the court far afield from the required, primary analysis under Delaware law, which was "testing whether a transaction complies with the applicable business entity statute or the organizational documents of the entity." Indeed, highlighting this fact was the impossibility of what plaintiffs proposed as substantially equivalent outcomes through merger and amendment. Both KMEP's governing partnership agreement and Delaware Revised Uniform Limited Partnership Act Section 17-211 authorize mergers that result in the conversion of limited partnership units into the right to receive other consideration, including cash or the securities of another type of business entity. But no amendment to KMEP's partnership agreement could ever convert KMEP into something different from what it is—a limited partnership—and thus change the common units of the limited partnership to common stock in Kinder Morgan (or any other corporation). Laster labeled this "the alchemist's quest."

Laster's opinion in *Kinder Morgan* should remind attorneys practicing in the Chancery Court to take account of the formal boundaries of Delaware business entities in crafting their arguments. The opinion is also a timely reminder that the Chancery Court is no stranger to forms of business entities beyond the C corporation, and the laws and agreements that govern them.

James L. Hallowell *is a litigation partner in the New York office of Gibson, Dunn & Crutcher. His focus includes securities and mergers and acquisitions litigation.*

Brian R. Morgenstern *is a litigation associate in the New York office of the firm.*