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IN THE SUPREME COURT OF THE STATE OF DELAWARE

EMPLOYEES RETIREMENT SYSTEM OF THE CITY OF ST. LOUIS, Plaintiff Below, Appellant, v. TC PIPELINES GP, INC., TRANSCANADA AMERICAN INVESTMENTS, LTD., and TRANSCANADA CORPORATION, Defendants Below, Appellees, -and- TC PIPELINES, LP, Nominal Defendant Below, Appellee.	No. 291, 2016 Appeal from the Letter Decision and Final Order dated May 11, 2016 of the Court of Chancery of the State of Delaware, C.A. No. 11603-VCG

APPELLANT'S REPLY BRIEF

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TABLE OF CONTENTS

Page

TABLE OF CITATIONS

Page(s)

CASES

STATUTES AND RULES

PRELIMINARY STATEMENT

The underlying question in this case is how far will Delaware go in allowing a limited partnership agreement to insulate a general partner from challenges to transactions with affiliates that are blatantly unfair to the partnership? Defendants' brief[1] suggests that there are no limits, that as long as a conflicts committee issues an opinion that the transaction is "fair and reasonable" to the partnership, there is no remedy, even if the committee acts in bad faith and violates a contractual provision that the fairness and reasonableness of the transaction must be "considered in the context of all similar or related transactions." A160. It is respectfully submitted that absent an explicit contractual provision permitting a conflicts committee to act in bad faith, this Court should not hold that special approval by a conflicts committee acting in bad faith can conclusively preclude claims against the general partner for causing the partnership to enter into a conflict of interest transaction that is unfair to the partnership.

The LPA in this case contains no such provision explicitly allowing reliance on Special Approval by the Conflicts Committee even if the Committee acts in bad faith. There is no provision at all in the LPA that describes the standard of conduct by which actions of the members of the Conflicts Committee are to be governed.

[1] Appellees' Answering Brief, filed Aug. 24 2016 ("Def. Br."). Terms used herein have the meanings as indicated in Appellants' Opening Brief, dated July 25, 2016 ("Pl. Br."). Emphasis in quoted material has been supplied and internal quotation marks in such material omitted.

Undoubtedly, when the LPA was executed, none of the parties thereto conceived that the members of the Committee would act in bad faith and violate LPA §7.9(c), the provision that requires that the fairness and reasonableness of a transaction be "considered in the context of all similar or related transactions." A160. In such unanticipated circumstances, there is a gap to be filled by the implied covenant of good faith and fair dealing.

The conclusion of the Court below, that the obligation of the Conflicts Committee to decide whether the transaction is fair and reasonable supplies the standard of conduct, is unsupportable. Defining the question the Committee must answer does not provide a standard of conduct to be followed in trying to answer the question, and Defendants do not purport to try to support the Court's approach. Nor do they supply any reasoned analysis that the LPA was intended and should be construed to allow the General Partner to rely on the Special Approval safe harbor where, as here, the Conflicts Committee acted in bad faith.

For the reasons set forth below and in Plaintiff's Opening Brief, it is respectfully submitted that the decision below should be reversed.

I. THE IMPLIED COVENANT OF GOOD FAITH AND FAIR DEALING PRECLUDES THE GENERAL PARTNER FROM RELYING ON THE SPECIAL APPROVAL SAFE HARBOR, BECAUSE SUCH APPROVAL WAS GIVEN IN BAD FAITH

A. DEFENDANTS FAIL TO OVERCOME PLAINTIFF'S SHOWING THAT THERE IS A GAP IN THE LPA REGARDING THE STANDARD OF CONDUCT GOVERNING THE MEMBERS OF THE CONFLICTS COMMITTEE

Initially, Defendants argue that the covenant of good faith and fair dealing has no role to play here at all because, according to Defendants, it can only be invoked when "unanticipated events" arise. Def. Br. 2, 21. Defendants then argue that because dropdown transactions could have been anticipated when the LPA was executed, the covenant cannot be invoked. Def. Br. 12-13. Defendants are in error.

While a dropdown transaction might have been anticipated, unitholders could not have anticipated that a Conflicts Committee would act in bad faith and violate LPA §7.9(c), which requires that "[w]henever a particular transaction, arrangement or resolution of a conflict of interest is required under this Agreement to be 'fair and reasonable' to any Person, the fair and reasonable nature of such transaction, arrangement or resolution *shall be considered in the context of all similar or related transactions*." A160 (emphasis added).

Moreover, this Court explained in *Dunlap v. State Farm Fire & Cas. Co.*, 878 A.2d 434 (Del. 2005), that the implied covenant of good faith and fair dealing

is "best understood as a way of implying terms in the agreement, whether employed to analyze unanticipated developments *or* to fill gaps in the contract's provisions." *Id.* at 441. Here, there is just such a gap.

In its opening brief, Plaintiff demonstrated that there is a gap in the LPA, because it fails to specify any standard of conduct for the members of the Conflicts Committee, i.e., whether they are permitted to act in bad faith, or recklessly, or whether instead they are obliged to act in good faith. Pl. Br. 17-18. The Court below rejected this argument, holding that the LPA "explicitly supplies the standard the Conflicts Committee must follow; the LPA states that the Conflicts Committee must determine that the transaction is 'fair and reasonable' to TCP." Decision at 15. Plaintiff's Opening Brief showed that such holding inappropriately confuses the question that the Committee must address with the standard of conduct it must follow in resolving the question. Pl. Br. 18-19.

Defendants' brief does not seriously attempt to support the Court of Chancery's holding. Thus, their brief does not argue that the obligation to determine if a transaction is fair and reasonable supplies a standard of conduct by which the Committee's effort to resolve that question is to be governed. Instead, Defendants argue that the standard of conduct for the Conflicts Committee is the "sole discretion" language set forth in LPA §7.9. Def. Br. 18-19, 26-27. But Defendants explicitly disclaimed reliance on such position below:

> MR. RAJU: There was a discussion with my friend and the Court regarding what the standard is. Your Honor is correct. Our position – we're not relying on sole discretion as the standard. ….
>
> * * * *
>
> [W]e're not relying on sole discretion.

A238.

Assuming *arguendo* that Defendants can argue here what they explicitly disclaimed below, the "sole discretion" language does not supply a standard of conduct. As Plaintiff's counsel pointed out at the oral argument below with respect to the "sole discretion" language:

> MR. SABELLA: It doesn't provide a standard at all for whether special approval itself has to be in good faith or bad faith or on some other basis. I don't think it's fair to read that language as saying, well, that's the standard. I don't think there's any standard in this contract that tells the special committee can you act in good faith, can you act in bad faith.

A224.

Thus, the issue is not, as Defendants frame it, whether the Court should "enforce" the sole discretion language. Def. Br. 20 n.7.[2] The point is that the sole discretion language does not instruct as to whether the Committee can or cannot act in bad faith.

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[2] The cases cited by Defendants involved the issue of whether the sole discretion language entitled the Committee to consider only the interests of the partnership and ignore the interests of the limited partners, and the cases held that the Committee did not have to consider the interests of the limited partners. Def. Br. 20 n.7. Such cases have no relevance here, as Plaintiff is arguing that the subject transaction was unfair to the Partnership. A56-57.

There is no merit to Defendants' argument that applying the covenant of good faith and fair dealing to fill the gap and require the Committee to act in good faith would render the "sole discretion" provision meaningless. Def. Br. 20. Numerous cases involving contractual provisions providing discretion have nevertheless required the discretion to be exercised in good faith. *See* Pl. Br. 19-21. Defendants argue that the implied covenant can only be invoked when discretion is involved if the scope of the discretion is not specified in the contract, and that the covenant cannot be invoked if the matter is entirely discretionary. Def. Br. 23-24. The law, however, is to the contrary. As stated in *Dawson v. Pittco Cap. Partners, L.P.*, 2012 WL 1564805, at *24 (Del. Ch. Apr. 30, 2012), a case involving an implied covenant claim relating to a limited partnership agreement eliminating fiduciary duties, "[e]ven where a contract creates completely discretionary rights, such rights must still be exercised in good faith." *See also Wilmington Leasing, Inc. v. Parrish Leasing Co., L.P.*, 1996 WL 560190, at *2 (Del. Ch. Sept. 25, 1996) ("Where either the definition or the declaration of occurrence of the condition is left to the sole discretion of the invoking party, the application of a good faith standard to the enforcement of conditions is appropriate.").

The question is what would the parties reasonably have expected if they had thought about the issue. Giving someone sole discretion hardly necessarily means

that the party can act deceitfully or otherwise in bad faith. Could any Court conclude that as a matter of law, the parties expected that bad faith conduct was permitted by this provision? *See In re ASB Allegiance Real Estate Fund v. Scion Breckenridge Managing Member, LLC*, 50 A.3d 434, 443 (Del. Ch. 2012), *mod. on other grounds*, 68 A.3d 665 (Del. 2013) ("[A] court can presume that the question 'Can I lie to you?' would have been met with a resounding 'No'.").[3]

Wide of the mark is Defendants' argument that the implied covenant cannot be invoked if the contract generally addresses the conduct at issue. Def. Br. 19. "[R]ecent authority teaches that a claim for violation of the implied covenant of good faith and fair dealing can survive if, notwithstanding contractual language on point, the defendant failed to uphold the plaintiff's reasonable expectations under that provision." *Renco Group, Inc. v. MacAndrews AMG Holdings LLC*, 2015 WL 394011, at *6-7 (Del. Ch. Jan. 29, 2015). Courts recognize that "[g]aps also exist because some aspects of the deal are so obvious to the participants that they never think, or see no need, to address them." *In re El Paso Pipeline Partners, L.P. Deriv. Litig.*, 2014 WL 2768782, at *16 (Del. Ch. June 12, 2014). Whether a Conflicts Committee can act in bad faith is one such aspect.

[3] Defendants' reliance on *Brickell Partners v. Wise*, 794 A.2d 1 (Del. Ch. 2001) (Def. Br. 14-15), is misplaced. That case did not involve any interpretation of the "sole discretion" language or any argument as to whether the Conflicts Committee could act in bad faith. The case simply involved the issue – not relevant here – as to who could serve on the Conflicts Committee.

B. PLAINTIFF IS NOT MAKING A NEW ARGUMENT ON APPEAL

Defendants argue that Plaintiff's position that the "fair and reasonable" language in the LPA fails to provide a standard of conduct governing the Conflicts Committee is a new argument not raised below. Def. Br. at 17 & n.6. Defendants' assertion is belied by the transcript of the argument in the Court of Chancery:

> THE COURT: Isn't the standard they're arguing for fairness and reasonableness? ….
>
> MR. SABELLA: Yes, but do they have to act in good faith? Do they have to act in bad faith in making that determination? This contract doesn't say that. It doesn't specify either way. ….
>
> * * * *
>
> It doesn't tell them what the standard of conduct is for their evaluation of fair and reasonable.

A226-27. Given this colloquy, it is hard to understand how Defendants can assert that Plaintiff did not argue below that there is a gap in the LPA because the obligation to determine if the transaction is fair and reasonable does not supply a standard of conduct.

Arguments raised during oral argument satisfy the Rule 8 requirement. *See North River Ins. Co. v. Mine Safety Appliance Co.*, 105 A.3d 369, 383 (Del. 2014) ("We are satisfied that the broader issue [advanced on appeal] was sufficiently raised in the Court of Chancery during ... oral argument on the parties' Cross Motions for Judgment of the Pleadings."). Furthermore, assuming, *arguendo*, that Plaintiff did not explicitly raise the arguments advanced in his appeal below, he did

so implicitly, which also satisfies Rule 8. *See Telxon Corp. v. Meyerson*, 802 A.2d 257, 263 (Del. 2002) ("The corporate opportunity theory, too, was implicitly raised below, in the argument that Meyerson breached his duty of loyalty.").

C. DEFENDANTS' DISCUSSION OF *KINDER MORGAN* IS INACCURATE

As pointed out in Plaintiff's Opening Brief (Pl. Br. 23), in *In re Kinder Morgan, Inc. Corp. Reorg. Litig.*, 2015 WL 4975270, at *8 (Del. Ch. Aug. 20, 2015), *aff'd sub nom. Haynes Family Trust v. Kinder Morgan G.P., Inc.*, 2016 WL 912184 (Del. Mar. 10, 2016) (Def. Br. 15), the Court of Chancery stated that in granting special approval, the "members of the Committee … had to believe in good faith that the MLP Merger was in the bests interests of the Partnership" – a statement that this Court's opinion in that case did not address. Defendants assert that such statement by the Court of Chancery "was based on an express provision of the partnership agreement at issue in that case, which (as Plaintiff admits) has no analog here." Def. Br. 15 (citing *Kinder Morgan*, 2015 WL4975270, at *5).

However, the provision in the agreement in *Kinder Morgan* that the Court was discussing in the opinion at *5 to which Defendants refer was § 6.10(d), which imposed an explicit good faith requirement on the *general partner*, not on the *conflicts committee*. Comparable language appears in the LPA here in § 7.10(d) (A160). The provision in *Kinder Morgan* governing the conflicts committee was § 6.09(a), which provided, like LPA § 7.09(a) in the case at bar, that in

determining if the transaction is fair and reasonable to the partnership, the committee could consider factors that it "determines in its sole discretion to be relevant, reasonable or appropriate." *Id*. at *6.

Defendants' reliance on this Court's affirmance of the dismissal in *Kinder Morgan* is misplaced. *See* Def. Br. 15. The issues in *Kinder Morgan* were whether the individuals appointed to the committee were too conflicted to serve on it, and whether the transaction had to be fair to the limited partners as opposed to being fair to the partnership. 2015 WL 4975270, at *8-11. The issue here – whether the Special Approval safe harbor is satisfied where the Committee acted in bad faith in approving a transaction grossly unfair to the partnership and violative of LPA § 7.09(c) – was not presented in *Kinder Morgan*. Indeed, in *Kinder Morgan* the allegations supported the inference "that the Committee acted reasonably and in the best interests of the Partnership." *Id*. at *8. *See also* Pl. Br. 16 n.6.

D. THE "CONCLUSIVE PRESUMPTION" LANGUAGE DOES NOT DEFEAT PLAINTIFF'S CLAIM

Defendants' brief repeatedly references the language in the LPA that Special Approval constitutes "conclusive" evidence of the fairness and reasonableness of a conflict-of-interest transaction. *See, e.g.*, Def. Br. 14-15. They then argue that Plaintiff is trying to ignore or rewrite that provision. *Id*. This is not so.

Plaintiff's position is that because the LPA does not address the standards governing the members of the Conflicts Committee, i.e., whether they can act in bad faith, one must turn to the implied covenant, which requires that they act in good faith. This requirement of good faith then becomes an implied term of the contract. *Quadrant Structured Prods. Co. v. Vertin*, 2013 WL 3233130, at *22 (Del. Ch. June 20, 2013). Since the Committee members did not act in good faith, their Special Approval was not in accordance with the terms of the LPA and is invalid. "A breach of the implied covenant is a breach of contract." *Rossdeutscher v. Viacom, Inc*., 768 A.2d 8, 20 (Del. 2001). Thus, contrary to Defendants' assertion (Def. Br. 13), Special Approval in compliance with the terms of the LPA was not obtained. Hence, the "conclusive" evidence language, which applies only if Special Approval is given in accordance with the provisions of the LPA, does not apply.

The various hypotheticals discussed in Plaintiff's Opening Brief, such as situations involving million dollar gifts to the CEO or bribery (Pl. Br. at 24-26), illustrate the point. Notwithstanding Defendants' attempt to distinguish those situations, Def. Br. 27-29,[4] Defendants' concession that the implied covenant can

[4] The attempt to distinguish the hypotheticals fails. For example, Defendants argue that a Conflicts Committee approving a multi-million dollar gift to the CEO's family "is clearly outside the reasonable expectations of the parties," but that a dropdown transaction is not. Def. Br. 28. But a Committee acting in bad faith and approving a transaction departing dramatically from *(Cont'd)*

be invoked in those situations vitiates their argument that purported Special Approval is "conclusive" in all circumstances.

E. THE COMPLAINT ADEQUATELY ALLEGES BAD FAITH BY THE CONFLICTS COMMITTEE

"[T]o allege a breach of a contractual duty to act in good faith, a complaint need only allege facts related to the alleged act taken in bad faith, and a plausible motivation for it." *Clean Harbors, Inc. v. Safety-Kleen, Inc*., 2011 WL 6793718, at *7 (Del. Ch. Dec. 9, 2011) (internal quotation marks omitted) (noting that this is a minimal standard, the purpose of which is to give defendants notice of the claims against them). The allegations of the Complaint satisfy this test.

As noted above, the LPA required that "the fair and reasonable nature" of the 2015 GTN Dropdown "be considered in the context of all similar or related transactions." A160. In approving a transaction that was grossly unfair when compared to the prior transactions, the Conflicts Committee acted in bad faith.

As the Complaint alleges, in the 2011 GTN Dropdown the Partnership purchased a 25% interest in GTN for $405 million, a deal with an EV/EBITDA multiple of 9.4x. A18-19 ¶¶29-30. In the 2013 GTN Dropdown, the Partnership purchased an additional 45% interest for $750 million, a deal with an EV/EBITDA

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prior transactions and in so doing violating the dictates of LPA §7.9(c) (A160) is also clearly outside the reasonable expectation of the parties. *See* Pl. Br. 24-26.

multiple of 9.9x and 11.0x (depending on which years' earnings were used in the calculation). *Id.*

But in the 2015 GTN Dropdown, the Partnership purchased the remaining 30% for $351 million, plus the issuance of the Class B units to TransCanada. A10-11 ¶5. The Class B units entitle TransCanada to substantial distributions of the cash flow from the pipeline, in perpetuity. A17 ¶25. Based on GTN's historical performance, from 2016 through 2019 TransCanada will receive approximately $16 million per year (versus $20 million a year for the Partnership), and $4 million in perpetuity every year thereafter. A17-18 ¶¶26, 28. Taking into account this redistribution of cash flows, the EV/EBITDA multiple of the 2015 GTN Dropdown is 14.6x, much higher than the 9.4x and 9.9x / 11.0x multiples associated with the prior GTN dropdowns. A18-19 ¶¶29-30.

Defendants denigrate the analysis regarding the multiple for the 2015 GTN Dropdown, referring to this as "plaintiff's re-calculation" of the EV/EBITDA multiple. Def. Br. 34 n.11. Such assertion overlooks the allegations of the Complaint. The analysis of the EBITDA multiple for the 2015 GTN Dropdown is not something created by Plaintiff, but rather was set forth in an analysis published by Wells Fargo Securities. *See* A24 ¶43b.

Defendants ask the Court to reject the allegations of the Complaint and instead engage in a complicated economic analysis of the three transactions in

order to conclude that the 2015 GTN Dropdown was not materially worse for the Partnership than the prior two transactions. On a motion to dismiss, this is not appropriate. Furthermore, it is readily shown that Defendants' analysis is fatally flawed.

Defendants' conclusion that the Partnership paid less in the 2015 GTN Dropdown than it did in the prior transactions, *see* Def. Br. 32-33, should be rejected. First, Defendants' chart comparing transaction prices sets the transaction price of the 2015 GTN Dropdown at $446 million. Def. Br. 32. That price, however, includes the arbitrary assignment of $95 million as the value of the Class B units acquired by TransCanada. The $95 million price assigned to the Class B units was agreed to solely by TCPGP and TransCanada. A10-11 ¶5. That has never been market tested. If the value of what TransCanada received is much higher, as Plaintiff contends is the case, then the comparison of transaction prices is wholly fallacious.

Furthermore, Defendants' chart assumes that the value of GTN remained the same in 2011, 2013 and 2015, so that the transaction prices can just be added together. There is no basis for that key assumption. But without that assumption, the column in the chart entitled "Transaction Price as a Percentage of Aggregate Price" is meaningless.

Since Defendants' assertion that the Partnership paid $34 million less in the 2015 GTN Dropdown than in the prior deals, Def. Br. 33, depends on the validity of their chart, Defendants' assertion is totally unreliable and unreasonable. This is why Plaintiff's approach, using a comparison of the EV/EBITDA, is the far superior approach.

Defendants' assertion that the Complaint states that the total purchase price for the 2015 GTN Dropdown was "'in line with the prices paid' by TCP in the prior GTN dropdowns" (Def. Br. 7) is highly misleading. What the Complaint pointed out in that paragraph[5] is that while on its face the 2015 GTN Dropdown price seems similar to the amounts paid previously, that fails to take into account that there was no diversion of revenues in the prior transactions pursuant to Class B shares as there is in the 2015 GTN Dropdown. The Complaint paragraph concludes: "When this effect of the Class B units is taken into account, the deal is much more advantageous to TransCanada than were the previous two all-cash transactions in which TCP initially acquired its 70% interest in the pipeline." A11 ¶6.

The Court of Chancery assumed for purposes of its Decision that the transaction here "is materially less favorable to TCP compared to the prior GTN

[5] The Complaint paragraph containing this statement is ¶6, which appears on A11, not on A14 as Defendants' Answering Brief states.

dropdowns." Decision at 7. On this motion to dismiss, this Court should reject Defendants' invitation to resolve the issues of fact relating to how the 2015 GTN Dropdown compares with the prior transactions, and should reject Defendants' conclusion that it was not materially less favorable.

CONCLUSION

For the reasons set forth herein and in Appellant's Opening Brief, it is respectfully submitted that the decision below should be reversed.

Dated: September 8, 2016

Respectfully submitted,

GRANT & EISENHOFER P.A.

/s/ James J. Sabella

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