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10 MLP Governance Facts

MLPs possess unique governance characteristics as compared to corporations.

The number of master limited partnerships (MLPs) has grown significantly over the past five years, increasing from 59 in 2009 to over 100 in 2013. An MLP is a partnership or limited liability company that is traded on a stock exchange. In contrast to corporations, partnerships generally do not pay federal income tax at the entity level. However, publicly traded partnerships are taxed as corporations unless 90 percent of the gross income is "qualifying income." The most prominent category of qualifying income relates to natural resources activities.

This article examines the unique governance characteristics of MLPs.

1. **General Structure** An MLP has both limited partners and a general partner. The general partner possesses the exclusive management powers over the business and affairs of the MLP and the Board of Directors is typically at this level. Directors owe duties to the MLP and all of its unitholders (including the sponsor) under the MLP's partnership agreement.
2. **Governance Differences** There are several important differences between the overall governance structure of an MLP and a publicly traded corporation, including the following:

	Corp	MLP
Board comprised of a majority of independent directors	Yes	No
Audit Committee Requirement	Yes	Yes
Compensation Committee Requirement	Yes	No
Nominating and Governance Committee Requirement	Yes	No
Conflicts Committee	No	Yes
Shareholder vote required to issue more than 20% of shares outstanding	Yes	No
Shareholder vote required to issue shares to affiliates	Yes	No
Shareholder vote required to authorize shares for issuance under equity compensation plans	Yes	Yes
Subject to fiduciary duties of care and loyalty	Yes	No
Ability to contractually modify customary fiduciary duties	No	Yes

3. **Conflicts Committee** In addition to an independent audit committee, an MLP has a conflicts committee comprised of two or more independent directors. This committee reviews specific matters as authorized by the Board of Directors that may involve conflicts of interest.

4. **Fiduciary Duties** The Delaware Revised Uniform Limited Partnership Act enables a general partner to expand, restrict or eliminate its duties, including fiduciary duties, to the partnership and its unitholders; provided that the implied contractual covenant of good faith and fair dealing may not be eliminated. An MLP's partnership agreement will contain provisions that waive or consent to conduct by the general partner and its affiliates that might otherwise raise issues as to compliance with default fiduciary duties or applicable law.

When acting as general partner:	must act in "good faith," meaning it subjectively believed that the decision was in the best interests of the MLP; the general partner will not be subject to any other standard under applicable law, other than the implied contractual covenant of good faith and fair dealing.
When acting in its individual capacity:	may act free of any duty or obligation to the MLP or its limited partners, other than the implied contractual covenant of good faith and fair dealing.

5. **Good Faith** There are two concepts of "good faith" associated with MLPs:

Concept	Source	Explanation
Contractual standard of "good faith"	Partnership agreement	The person ***subjectively believed*** that the decision was in the best interests of the MLP
Implied contractual covenant of good faith and fair dealing	Common law	The implied covenant is a judicial construct that requires that a party refrain from arbitrary or unreasonable conduct that has the effect of preventing the other party to the contract from receiving the benefits of its bargain. When exercising a discretionary right, a party to the contract must exercise its discretion reasonably.

6. **Sources of Conflict** Conflicts of interest may arise between the controlling shareholders of the general partner and their affiliates (including the general partner's officers and directors), on the one hand, and the MLP and its limited partners, on the other hand. The most common source of conflicts will be transactions between the general partner's controlling shareholders and the MLP, such as asset "drop-downs" and related commercial arrangements.

7. **Conflict Resolution** An MLP's partnership agreement will contain a provision that allows the general partner and its directors to resolve conflicts of interest in a clear and decisive manner. An MLP's partnership agreement generally will provide that, whenever a potential conflict of interest exists, any resolution or course of action by the general partner in respect of such conflict of interest (1) shall be permitted; (2) shall be deemed approved by all partners; (3) shall not constitute a breach of the partnership agreement; and (4) shall not constitute a breach of any duty stated or implied by law or equity, **IF** the resolution or course of action in respect of such conflict of interest meets any of the following conditions:

- Approved by Special Approval (which is approval by a majority of the members of a properly structured and functioning conflicts committee)
- Approved by the vote of a majority of the outstanding common units (excluding common units owned by the general partner and its affiliates)
- On terms no less favorable to the MLP than those generally being provided to or available from unrelated third parties
- Fair and reasonable to the MLP, taking into account the totality of the relationships between the parties involved (including other transactions that may be particularly favorable or advantageous to the MLP)

8. **Conflicts Committee** A properly structured and functioning Conflicts Committee should generally include the following characteristics:
    - At least two members
    - Members satisfy the independence requirements in the partnership agreement
    - Members exercise independent judgment
    - Members have no personal interest in the transaction being evaluated
    - Members are well informed and act with due care in making a determination (including taking the appropriate time necessary to make a decision)
    - The committee is represented by independent legal and financial advisors (in most cases)

9. **Unitholder Votes** The following summarizes the unitholder vote required for the matters specified below. Matters that require the approval of a "unit majority" require:
    - During the subordination period (typically three to five years), the approval of a majority of the outstanding common units, excluding those common units held by the General Partner and its affiliates, and a majority of the outstanding subordinated units, voting as separate classes
    - After the subordination period, the approval of a majority of the outstanding common units

Topic	Required Vote
Issuance of additional units	No approval rights
Transfer of incentive distribution rights	No approval rights
Reset of incentive distribution rights	No approval rights
Transfer of ownership interest in General Partner	No approval rights
Amendment of partnership agreement	Certain amendments may be made without unitholder vote; other amendments with a unit majority
Merger or sale of substantially all assets	Unit majority
Dissolution	Unit majority
Withdrawal of the General Partner	Unit majority, excluding common units held by the General Partner and is affiliates, prior to the 10th anniversary of the initial public offering

Removal of the General Partner	Two thirds of outstanding units, voting as a single class, including units held by the General Partner and its affiliates
Sale by the General Partner of its general partner interests (except for sale of all assets)	Unit majority

10. **Director Protection** The directors of an MLP have several alternatives for protecting themselves from personal liability, including:
    - A director's best protection is acting with due care, in good faith and without conflict.
    - A director will not be liable for monetary damages to the MLP or its unitholders as a result of any act or omission by the director unless (1) a final and non-appealable judgment has determined that the director acted in bad faith, or (2) in the case of a criminal matter, the director acted with knowledge that the conduct was criminal.
    - A director is entitled to indemnity from the MLP for losses by reason of being a director unless (1) there has been a final and non-appealable judgment determining that the director acted in bad faith, or (2) in the case of a criminal matter, the director acted with knowledge that the conduct was unlawful.
    - A director may receive expense advancement, pursuant to the MLP partnership agreement, in defending a claim, subject to the director undertaking to repay these advances if indemnification is later determined to not be available.
    - A director is insured against liability for criminal, administrative, civil, and regulatory proceedings based on actual or alleged acts, errors, omissions, misstatements, neglect, or breach of duty committed or allegedly committed.

For additional insight on MLP governance issues from Sean Wheeler and Brett Braden, please access their recent audio webcast here.

For further information on MLPs, visit the MLP Portal at **www.lathammlp.com**.

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