

# Requiring Greater Accountability of MLPs for Investors

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In recent years, master limited partnerships have gained increasing popularity among stock investors.

But MLP investments often carry significant risks because investors in these companies generally do not receive the same fundamental protections owed to shareholders of corporations, or even to partners under ancient common law principles.

Specifically, because most MLPs are structured as either Delaware limited partnerships or limited liability companies, Delaware law permits them, through their operating agreements, to modify or altogether eliminate the fiduciary duties that company management would otherwise owe shareholders.

MLPs are popular among investors for a number of reasons. Among other things, they often pay hefty cash dividends. The Alerian MLP index — a composite of 50 prominent MLPs and a leading benchmark of MLP performance — had an average annual dividend yield of 5.8%, as of Dec 31. By comparison, the S&P 500 companies had a 1.9% average dividend yield.

MLPs, while they are publicly traded companies listed on major U.S. stock exchanges, are not structured as corporations. MLPs are so-called alternative entities organized as either limited partnerships or limited liability companies.

For example, a manager of any publicly traded corporation owes shareholders an unqualified duty of loyalty, which requires that manager to place the interests of shareholders ahead of his or her own interests. The manager further owes fundamental duties of care and candor. But a manager of an MLP typically owes no such duties. This means the MLP manager may with impunity possess, for instance, the ability to engage in related-party transactions with the MLP on terms more favorable to the manager than shareholders, or to effectuate mergers or acquisitions for self-interested reasons.

Indeed, in 2011, Mohsen Manesh, assistant professor of law at the University of Oregon School of Law, conducted research concerning the extent to which MLPs modify or eliminate their managers' duties to investors. MLPs overwhelmingly "have used alternative entity law to reduce managerial accountability," Mr. Manesh concludes in his "Contractual Freedom Under Delaware Alternative Entity Law: Evidence from Publicly Traded LPs and LLCs," published 2012 in the Journal of Corporate Law.

Among other things, Mr. Manesh found that more than 88% of MLPs "totally waive(d) the fiduciary duties of managers or eliminate(d) liability arising from the breach of fiduciary duties," and that only two MLPs had expressly adopted traditional fiduciary duties. This should be cause for serious concern.

According to the National Association of Publicly Traded Partnerships, there are more than 100 MLPs listed on U.S. stock exchanges, with more than \$400 billion in market capitalization invested in those companies. And these numbers are only increasing: 14 MLPs conducted initial

public offerings in 2012, the largest number of MLP public offerings since 2009, according to Dealogic Ltd. Another 20 MLPs went public in 2013.

But investors cannot — and should not — have confidence in these investments unless and until they are given the same fiduciary protections afforded to shareholders of corporations. In the past year alone, we've seen several instances of allegedly aggrieved MLP investors seeking recourse in Delaware courts. The courts' message to these investors has been generally consistent: "buyer beware."

In one case from 2013 — *Norton vs. K-Sea Transportation Partners LP* — that involved the merger of an MLP, the Delaware Supreme Court found the MLP's manager had used its position to extract an excessive payment for itself at the expense of the MLP's investors. But the MLP's operating agreement included a provision stating the manager would be conclusively presumed to have satisfied its duties to investors if the manager relied upon the advice of an investment banker. Because the manager had retained an investment banker to advise on the merger, the court dismissed the case. According to the Supreme Court of Delaware, the MLP investors were simply out of luck, as they had "willingly invested in a limited partnership that provided fewer protections to limited partners than those provided under corporate fiduciary duty principles" and were therefore "bound by ... (that) investment decision."

In another case last year — *Allen vs. Encore Energy Partners LP* — the Delaware Supreme Court was arguably blunter, telling an MLP investor that if he "seeks the protections the common law duties of loyalty and care provide, he would be well-advised to invest in a Delaware corporation."

These decisions invite an obvious question: Shouldn't investors in all publicly traded companies — irrespective of whether those companies are organized as corporations, limited partnerships or limited liability companies — receive fiduciary protections? In any stock investment, the shareholder — i.e., the true owner of the company — entrusts managers to run the business and affairs of the company. A fundamental consequence of that, at least for corporations, is that the law imposes upon those managers fiduciary obligations to shareholders. Even with respect to partnerships, this has been established law for nearly a century. As Supreme Court Justice Benjamin N. Cardozo famously explained more than 85 years ago in the seminal case *Meinhard vs. Salmon*, a managing partner is in effect a "trustee" who should be "held to something stricter than the morals of the market place." Thus, "(n)ot honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior." Fairness and common sense dictate the same rules should apply to any other company structure.

Accordingly, if institutional investors continue to invest in MLPs, they should be calling on lawmakers to make significant regulatory reforms that require greater accountability to investors. These reforms should include the mandatory imposition of traditional fiduciary duties upon all managers of publicly traded limited partnerships and limited liability companies.

In the meantime, investors should be demanding that MLPs amend their operating agreements to increase managers' responsibility to their shareholders.

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