Issues in Midstream Restructurings

Part III: The 1-2-3s of MLPs

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Issues in Midstream Restructurings: Series Overview

Part I: Covenants Running with the Land

Topics discussed:

- Overview of covenants running with the land
- Summary and analysis of recent decisions
- Paths for getting relieved from covenants running with the land
- Analysis of key factors in predicting the outcome

Part II: FERC and the Bankruptcy Process

Topics discussed:

- Jurisdiction over rejection of a FERC-filed contract
- Legal standard applicable to rejection
- Procedural considerations
- Options for addressing FERC-related concerns

Part III: The 1-2-3s of MLPs

Topics to be discussed:

- Fundamentals of MLP structure
- Benefits of MLP structure
- MLP structure in the oil and gas industry
- Bankruptcy considerations for an MLP

Glossary of Select MLP Terms

Term	Definition
“Common Units”	Limited partnership interests in an MLP that get sold to the public (a portion may also be retained by the sponsor/GP)
“IDR”	Incentive Distribution Rights – a form of carried interest that provides an MLP’s sponsor/general partner the right to receive an increasing share of cash distributions as certain benchmarks are met
“MQD”	Minimum Quarterly Distribution – minimum amount of cash flow the MLP intends to distribute on a quarterly basis, as stated in its SEC filings
“Sponsor”	The entity that forms the MLP and owns the MLP’s general partner. Generally a public or private parent company that creates the MLP as a subsidiary, or a private equity firm (may create MLPs on a project-by-project basis)
“Subordinated Units”	Limited partnership interests in an MLP that are retained by the sponsor/GP and are subordinated to common units

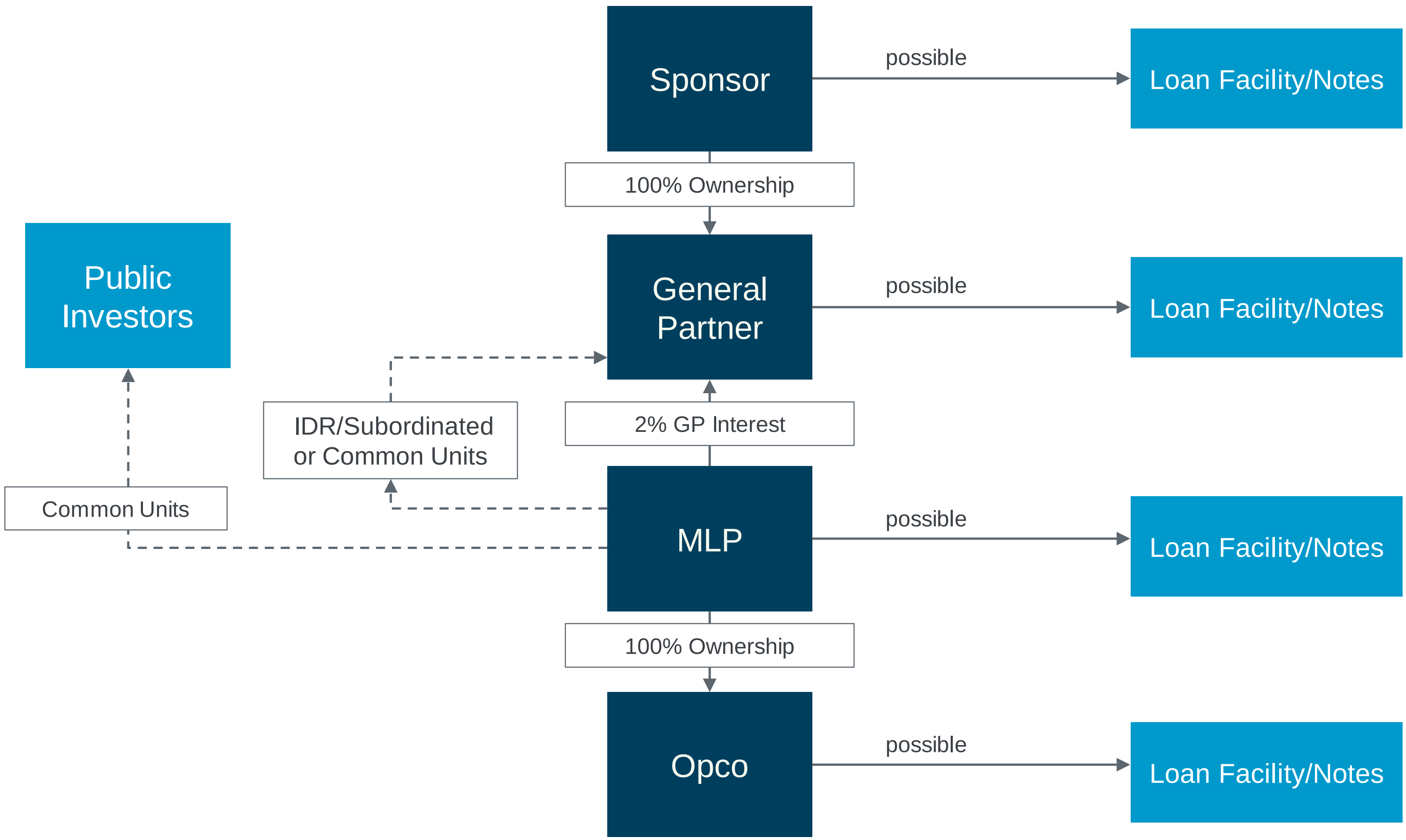
Key Characteristics of MLPs

<u>MLP basics</u>

- A master limited partnership ("MLP") is a publicly traded partnership that is listed on a national securities exchange
  - Owners of MLP units have the ability to buy and sell interests in the MLP
- Must be an entity recognized by state law and treated as a tax pass-through entity
  - Most commonly formed as a Delaware limited partnership, although can be formed as an LLC (usually a Delaware LLC) or state law trust (Delaware statutory trust)
  - All of the foregoing entities may be treated as partnerships for federal income tax purposes, although their governance structures vary
- Governed by applicable state law (usually Delaware partnership law) and the partnership agreement
- Ownership of the MLP is split between the public and the sponsor
  - Size of public ownership varies
  - Sponsor will retain (via a wholly owned entity) a 2% general partner interest and nonpublic limited partner interests
  - Sponsor (either directly or through a wholly owned entity) also holds "incentive distribution rights" (IDRs)
- Generally a two-tiered structure
  - The sponsor/general partner ("GP") are together seen as one tier
  - The second tier is the MLP and its wholly owned LLC or limited partnership, known as the "operating" entity or "Opco"
    - Opco owns (directly or indirectly) the operating assets and other operating subsidiaries of the MLP
- MLPs may raise debt at all levels (the sponsor, GP, MLP, and/or Opco)

Key Characteristics of MLPs (cont.)

CHART OF TYPICAL POST-IPO STRUCTURE



Key Characteristics of MLPs (cont.)

<u>Select benefits of the MLP structure</u>

- Companies elect to form MLPs primarily because of the tax benefits
  - Unlike shareholders of a corporation, which face double taxation at the corporate level and personal level, unitholders of an MLP are taxed only once, when the MLP earns income (not when cash is distributed)
  - When cash distributions exceed partnership income, the difference is treated as a return of capital to the limited partners and taxed as capital gains when the unitholders sell their interests
  - MLP holders are generally eligible for a “qualified business income” 20% deduction enacted in tax reform
  - Rates changed in tax reform, but MLPs continue to provide an advantage if this deduction is available
    - Pre-tax reform max federal rates: MLP partner on cash distribution – 39.6%; corporate shareholder on dividend – 48%
    - Post-tax reform max federal rates: MLP partner if pass-through deduction fully available – 29.6%; MLP partner without pass-through deduction – 37%; corporate shareholder on dividend – 36.8%
  - Biden plan to increase corporate tax to 28%, tax dividends at max rate of 39.6% and phase out “qualified business income” deduction would favor MLPs over corporations
    - Biden plan max federal rates: MLP partner on cash distribution – 39.6%; corporate shareholders on dividend – 56.5%
- Other advantages of the MLP structure for companies and investors include:
  - Efficient means for companies to strategically monetize assets and unlock value (because the sponsor retains control and has access to upside from distribution growth via its IDRs)
  - Lower cost of capital (as a result of the absence of taxes at the company level)
  - Attractive yields

Key Characteristics of MLPs (cont.)

The economic structure of an MLP revolves around cash flow

- MLPs are formed to monetize assets and achieve stable and predictable cash flows. They trade based on a multiple of cash flow
- An MLP generally is required by its partnership agreement to distribute all "available cash" to its unitholders
  - Contrast to REIT, required by applicable tax law (not contract) to distribute its income
  - The definition of "available cash" gives the GP wide discretion and is generally subject to (i) discretionary reserves established by the GP for operation of the business, (ii) cash necessary to comply with debt covenants, (iii) reserves necessary to provide for distributions for any of the next four quarters, and (iv) working capital borrowings after the end of a quarter
- MLPs often utilize mechanisms to promote cash distributions; there are generally two forms:
  - "Internal" support mechanisms (more common)
    - The sponsor's right to receive cash distributions may be subordinated to the public unitholders' distributions
      - Equivalent to issuing preferred stock to public investors and sponsor retains common stock
      - Result is that the public's "common units" will get paid before the sponsor receives its cash distributions
      - The MLP's governance documents may permit the GP to manipulate its subordinated shares and change the terms of the subordination, including converting the subordinated units to common units
      - Subordinated units are subordinate to the common units to the extent of the MQD; amounts above the MQD are distributed to common and subordinated units on a pro rata basis
  - "External" support mechanisms
    - GP can forgo its distribution and receive additional units in the MLP in exchange for such forfeiture
    - This provides the GP with the ability to increase its ownership in the MLP and thereby increase its voting power

O&G Companies as MLPs

MLPs and O&G Companies

- Although tax laws formerly permitted a wide range of industries to use MLPs, Congress severely restricted access to the MLP structure in the late 1980s. Presently, for an MLP to be taxed as a flow-through entity, at least 90% of its gross income must constitute "qualifying income," which includes, among other things, income and gain derived by the exploration, development, mining or production, processing, transportation or marketing of any mineral or natural resource, as well as certain passive-type income including interest, dividends and real property rents
  - There are certain exclusions, including renewables (such as agricultural products) and certain inexhaustible resources (solar power or wind) that do not constitute natural resources for purposes of these laws and cannot qualify for tax treatment as a pass-through entity
    - Persons with certain assets that are not eligible for MLP formation may opt instead to form "Yieldcos" to own, operate and acquire these assets (for example, contracted renewable and conventional generation and thermal infrastructure assets)
    - Like MLPs, Yieldcos position themselves as vehicles for investors to seek stable and growing dividend income from lower-risk, high-quality assets, but, whereas MLPs are formed as partnerships or LLCs (and thus can be treated as pass-through entities for federal tax purposes), Yieldcos are corporations
    - In a Yieldco structure, the sponsor and the public investors invest into the corporation that is the sole managing member of the Opco LLP. However, the structure is typically favorable only if the business has substantial tax deductions
- MLPs are employed across all sectors of the O&G industry – upstream, midstream, downstream and oilfield services
  - Majority of energy MLPs are focused on midstream pipeline and storage
    - Transportation of oil, gas and products thereof by truck, rail or barge to a retail outlet will not qualify for MLP treatment
  - Still, there are many MLPs focused on upstream, mining, oilfield services, and refining, among other things
  - Upstream MLPs may be more vulnerable to restructuring risk because they are more sensitive to the changes in the price of oil

Corporate Governance

- The sponsor generally retains 100% ownership of the MLP's GP and appoints the GP's board of directors
  - In accordance with the terms of the MLP's partnership agreement, the GP will have exclusive management control over the MLP (thus, the sponsor has only indirect control of the MLP via its appointment of the GP's directors)
  - The sponsor will also have the right to vote its common units and subordinated units in any matter requiring unitholder approval under the MLP's partnership agreement
- MLPs are required to have only three independent directors (whereas most public companies are required to have a majority of independent directors)
  - There is no limit to the number of non-independent directors, so MLPs often have a majority of non-independent directors
    - Can give rise to problematic related-party transactions, or allegations of insufficient oversight/unfair benefit to the sponsor/GP
  - SEC rules require the GP board to establish an audit committee composed entirely of independent directors. Most GPs use these directors to review related-party transactions and other potential conflicts between the MLP and the sponsor/GP
- The directors may have modified or limited fiduciary duties, and the partnership agreement may eliminate the duties of care and loyalty altogether
  - The Delaware Revised Uniform Limited Partnership Act provides for freedom of contract, allowing limited partnerships to restrict, expand, or eliminate fiduciary duties other than the "implied covenant of good faith and fair dealing"

Select Bankruptcy Considerations

- Lenders should carefully review the contracts, covenants and debt capacity at each tier of the MLP structure
  - As noted above, debt can be incurred by the sponsor, GP, MLP and/or Opco
  - Concerns for lenders at the sponsor and GP levels include:
    - Potential carve out of the MLP and Opco from some if not all of the restrictive covenants contained in the sponsor or GP credit facility. This includes restrictions on making distributions or investments, incurring additional debt or liens, selling substantial assets, or engaging in affiliate transactions
    - Also important to consider whether credit events occurring at the MLP/Opco level trigger rights and remedies for lenders of the sponsor/GP
      - The financial health of the two tiers is linked, and sponsor/GP lenders will want to be able to act upon the default of the lower tiers
    - Is the sponsor/GP-level debt contractually subordinated to the MLP/Opco debt? How much debt can the MLP/Opco incur and what other material contractual obligations exist?
  - The risks and concerns for lenders providing financing at the MLP/Opco level are the inverse of the foregoing concerns
- The corporate governance structure of MLPs creates certain risks in a distressed scenario and may make a restructuring more complicated
  - The sponsor/GP has significant control over the MLP and can assert its control to extract value from the MLP to the detriment of the MLP's common unitholders and/or lenders
  - Relative to shareholders of a public corporation, common unitholders of an MLP have very limited power to exercise influence over management of the MLP, either through voting rights or litigation
    - Voting rights of common unitholders are usually very limited under a typical partnership agreement, and the partnership agreement may make it difficult to remove the GP
    - Because Delaware partnership law allows the MLP to waive certain fiduciary duties of the GP's directors, common unitholders will have limited ability to use litigation or the threat of litigation to protect their interests and hold the GP accountable

Select Bankruptcy Considerations (cont.)

- In particular, the GP's control over the MLP may give rise to the following risks:
  - Risk that the GP can extract cash from the MLP
    - Even before cash flow problems are identified, the GP may have the ability to manipulate distributions or to extract additional funds from an MLP to the detriment of common unitholders and creditors. For example, the GP has discretion with respect to carve-outs from "available cash" and may be able to manipulate the terms of its subordinated units
  - Risk of related party transactions between the MLP and GP that favor the GP
    - Even where GPs have limited fiduciary obligations to the limited partners, courts may scrutinize the GP board's compliance with other contractual obligations contained in the partnership agreement
      - For example, in the recent case of *El Paso Pipeline Partners, LP*, an MLP purchased assets from its sponsor in a series of drop-down transactions, and the Delaware chancery court determined that the GP's conflict committee failed to comply with its obligation in the partnership agreement to determine the transaction to be in the best interest of the MLP
  - Risk of distribution "freeze" or clawback of distributions in the event of MLP's insolvency
    - In the event of a bankruptcy at the MLP level, public holders may seek to go after the sponsor/GP and to recover distributions made to them by the MLP
      - Due to the sponsor/GP's control over the MLP, these distributions may be more likely to be challenged if proper procedures were not followed
    - Creditors of the MLP may also have standing under Delaware law to enjoin or claw back certain improper distributions. However, claims asserting general mismanagement generally may be asserted only by limited partners (and, as discussed, may be specifically limited under the partnership agreement)
  - Risk of substantive consolidation of GP and MLP assets in a bankruptcy initiated by the GP
    - A distressed GP may seek bankruptcy protection and put the MLP in bankruptcy as well; the GP may also seek to substantively consolidate the respective entities
    - Some MLPs require approval from a majority of independent directors in order for the GP to place the MLP into bankruptcy; however, independent directors serve at the will of the GP and can be easily replaced
    - Some partnership agreements may limit the GP's power by making it an "event of withdrawal" if the GP itself goes into bankruptcy. Such an "event of withdrawal" can cause the GP to relinquish control over the MLP upon the GP's filing for bankruptcy. However, the terms of the partnership agreement are controlling, and some agreements may only require the GP to relinquish control in the event of a chapter 7 liquidation

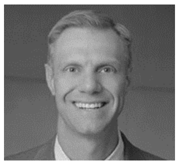
Select Bankruptcy Considerations (cont.)

- Because of the pass-through nature of MLPs, Cancellation of Debt ("*COD*") income realized in a bankruptcy will flow through to the unitholders of the MLP
  - The Federal Income Tax Code provides that income from the discharge of indebtedness does not include income by reason of discharge that occurs in a title 11 case or where the taxpayer is insolvent
  - However, for a pass-through entity such as an MLP, insolvency is measured at the partner level, i.e., the MLP's insolvency will not protect an MLP partner from COD income unless the partner is itself insolvent
  - Therefore, an MLP may attempt to convert into a C-corporation before entering into Bankruptcy, in order to shield its unitholders from COD income (if a C-corporation is under title 11 or insolvent, that would effectively shield from COD income). Individual investors also may attempt to incorporate their interests
  - However, these "blocking" techniques are not guaranteed to remedy all negative tax consequences for the unitholders and may give rise to additional tax costs and risks
  - Whether this blocking is possible may depend upon whether the relevant debt was issued by the MLP or a subsidiary Opco – the partnership agreements of MLPs often limit their ability to convert into corporations for tax purposes whereas a subsidiary Opco generally will have more flexibility
- MLPs and their unitholders should focus on ways to mitigate COD-related consequences
- Creditors of distressed MLPs should prepare to be equityholders of recapitalized MLPs
  - As a partner in a domestic partnership, MLP equityholders are engaged in a U.S. trade or business and must file U.S. tax returns
  - In any future bankruptcy, the former creditor and now equityholder will need to manage COD

Issues in Midstream Restructurings

PANELIST BIOS

Part III: The 1-2-3s of MLPs



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Davis Polk | Energy and Natural Resources Restructurings
Davis Polk has held leading roles in some of the largest energy and natural resource-related restructurings in recent years, including Chesapeake Energy Corporation, California Resources Corporation, PG&E, Sable Permian Resources, Cloud Peak Energy, Hornbeck Offshore Services, Ultra Petroleum, Key Energy Services, Chaparral Energy, Philadelphia Energy, EdgeMarc Energy, FirstEnergy Solutions, San Juan Offshore, Cloud Peak Energy, Murray Energy, Southcross, Odebrecht Engenharia e Construção S.A., Arena Energy, Fieldwood, and FTS International.