KAYE | SCHOLER

April 2, 2015

Bankruptcy & Restructuring Alert

The Price of Oil & the Potential for Master Limited Partnership Restructuring and Insolvencies

With the near-historic drop in oil prices, distressed investors are evaluating a myriad of investment opportunities in the oil industry and related fields. One particular area of focus when analyzing these energy-related opportunities are the master limited partnerships that many energy companies utilize in their corporate structure.

Drop in Oil Prices

During the fourth quarter of 2014 the price per barrel of crude oil declined approximately 40% (the WTI Crude Oil price dropped from approximately $92 a barrel to approximately $55 a barrel). This decline has prompted continuing analysis and speculation as to its cause, duration and long-term impact on the overall global economy. While decreasing prices of oil have had positive effects on some segments of the US economy (in the fourth quarter of 2014, the Dow Jones Industrial Average increased approximately 5.2%, the S&P 500 increased approximately 4.93% and the Nasdaq Composite increased approximately 5.4%), distressed investors are now evaluating a myriad of investment opportunities in the oil industry and related fields.

Notwithstanding the economic benefits of decreased oil prices, the drop poses significant risks for certain energy companies and attendant industries that support such companies. Halliburton has announced that it plans to cut 1,000 positions due to the depressed price of oil; BP will have a number of layoffs in connection with a $1 billion restructuring plan, and ConocoPhillips plans significantly to decrease spending in 2015 due to the "current environment". Companies that have invested in oil sands, shale oil, and offshore drilling are particularly vulnerable to the drop in oil prices because, generally, these ventures are only profitable at relatively high oil price thresholds. Commentators have observed that energy companies are attempting to address reduced oil revenue by drastically reducing capital expenditures. This may help such companies ride out the storm, but will likely wreak havoc on companies that provide capital expenditure services.

In recent years, energy companies have come to account for a larger portion of the credit market. The energy sector accounts for 4.6% of the S&P/LSTA Leverage Loan Index, up from 3.1% a decade ago[1] and 17% of the high-yield bond market, up from 8% in 2008[2].

Master Limited Partnerships

One particular area of focus when analyzing energy-related opportunities are the master limited partnerships (MLPs) that many energy companies utilize in their corporate structure. An MLP is a state law entity with publicly traded securities in the form of limited partnership interests. MLPs are treated as "pass-through" entities for tax purposes provided they earn certain "qualifying income." As such, MLPs are somewhat unique to the energy sector since, under the Internal Revenue Code of 1986 and the rules and regulations promulgated under it (the "Code"), "qualifying income" is limited, *inter alia*, to income and gains from exploration, development, mining, or production, processing, refining, transportation (including pipelines transporting oil or oil products) or marketing of any mineral or natural resource[3]. Although under the Code, MLPs are not required to distribute cash to their investors (as is the case with Real Estate Investment Trusts), an MLP typically distributes all of its available cash to its limited partners on a quarterly basis. As a result, MLPs have become an attractive option to investors searching for high yield investments in the current low interest rate environment.

Energy related MLPs are typically grouped into three separate categories: (i) exploration and production (referred to as "upstream" companies); (ii) pipeline and storage (referred to as "midstream" companies); and (iii) refining and processing (referred to as "downstream" companies)[4]. Commentators generally agree that upstream MLPs are most vulnerable to restructuring risk since they are very sensitive to changes in the price of oil. Additionally, because MLPs are particularly attractive for providing yield in a low interest rate environment, if interest rates rise we may see a significant market dislocation from the convergence of rising interest rates together with lower energy prices that could undermine the assumptions of the MLP business model.

MLP Structure

MLPs are formed by a "sponsor," the entity that indirectly controls the MLP through its creation and ownership of the general partner, which is the entity that manages the MLP. Generally, an MLP's sponsor will fall into one of two categories: (i) public or private parent companies that create the MLP as a subsidiary company or (ii) private equity firms that approach the creation and sale of MLPs on a project by project basis. For purposes of this article, we will focus on the

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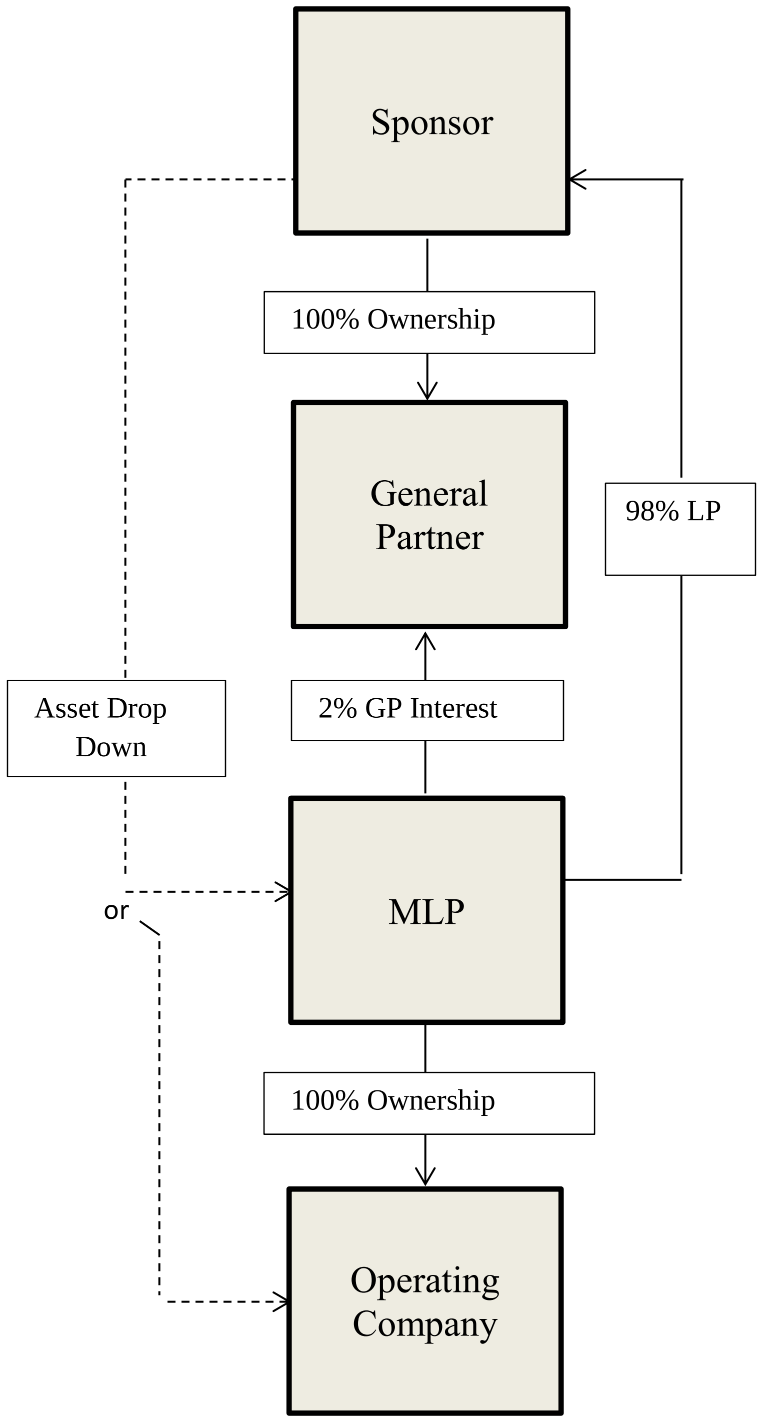
[1] According to S&P Capital IQ.
[2] See *Slipping on High Yield's Oil Slick*, Barrons November 15, 2014.
[3] See § 7704(d) of Code.
[4] According to Morgan Stanley's North America Midstream Energy MLPs Primer 3.0 dated April 17, 2013, MLPS are 14% exploration and production, 45% midstream and 7% downstream (remaining percent is real estate, propane, marine transportation, coal, minerals and timber, investments and other).

Pre-IPO MLP Structure

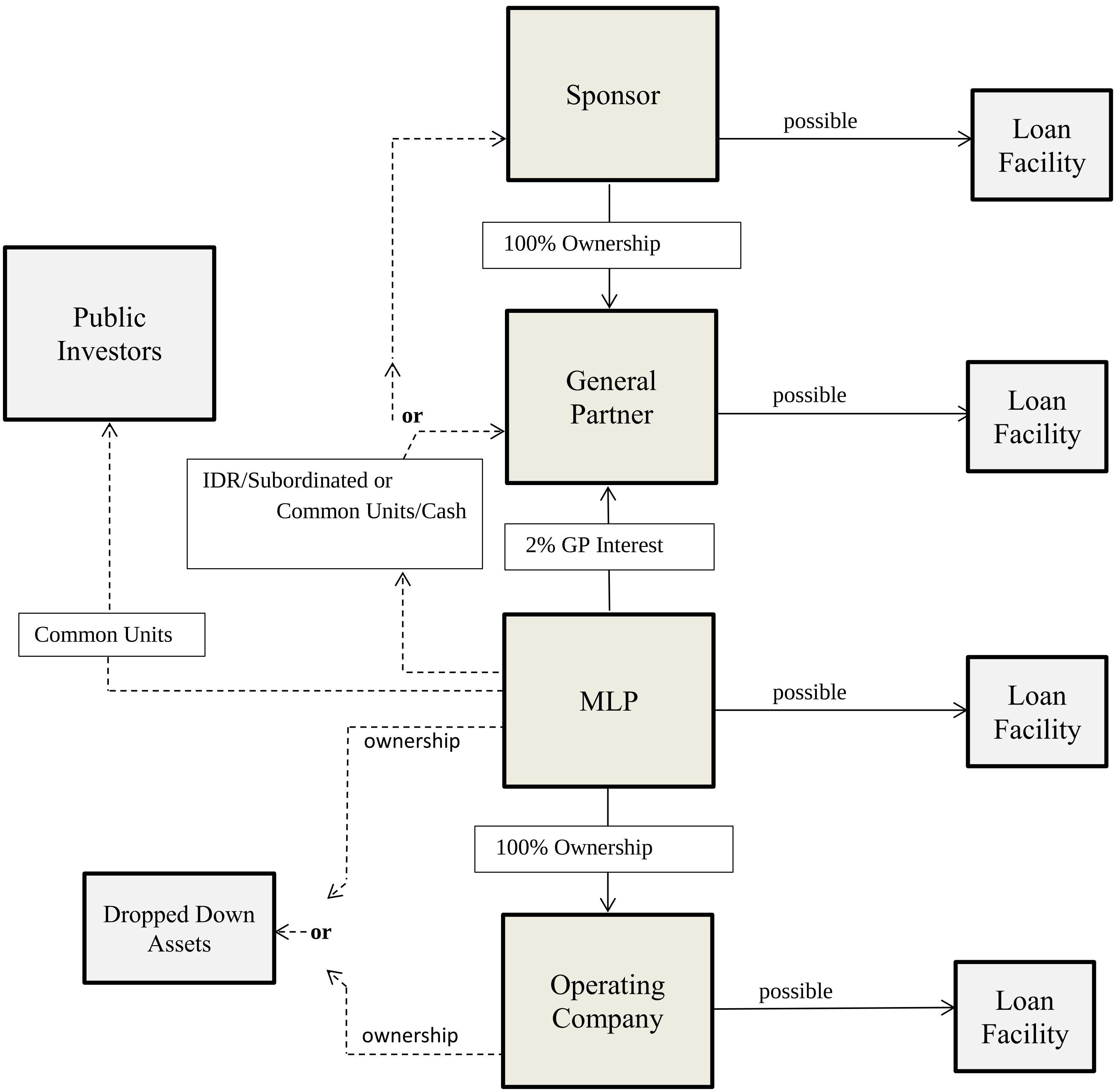


former. In both instances, the sponsor is interested in monetizing certain assets. The typical first step a sponsor will take when creating an MLP is creating the general partner (which will usually be formed as a limited partnership or wholly owned limited liability company). Next, the general partner and the sponsor will form the MLP (often as a limited partnership) and will usually split the ownership with the general partner receiving a 2% general partner interest and the sponsor receiving the remaining 98% as a limited partner interest. To create value in the MLP the sponsor may transfer, or “drop down,” the target assets into the MLP. Most often, MLPs are arranged as a two-tier structure, with the MLP as the upper tier and a limited liability company that is wholly owned by the MLP (and typically referred to as an operating company) as the lower tier. The assets that are contributed from the sponsor to the MLP may then again be dropped from the MLP into the operating company so the MLP can remain a pure holding company, while the assets are managed by the operating company.

Once the MLP structure is in place, the sponsor will then take steps to raise cash. This is typically achieved through an initial public offering (IPO) of the MLP’s limited partnership interests. In an MLP’s IPO: (i) the general partner will normally retain its 2% general partner interest; (ii) the sponsor (or an affiliate of the sponsor, sometimes the general partner) may receive a mix of assets including, cash, common units, subordinated units or incentive distributions rights; and (iii) the public investor receives common units.

An important aspect regarding the MLP structure is that it provides the ability to borrow money at many different levels of the structure because the sponsor, general partner, MLP and operating company each have the ability to incur debt. At times, MLPs may even utilize debt to meet their high cash distribution demands. However, as we outline below, the ability to enter into credit facilities on multiple different levels creates certain issues that should be given consideration when evaluating MLPs.

Post-IPO


Sponsor
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Loan Facility
100% Ownership
Public Investors
General Partner
or
possible
Loan Facility
IDR/Subordinated or Common Units/Cash
2% GP Interest
Common Units
MLP
possible
Loan Facility
ownership
100% Ownership
Dropped Down Assets
or
Operating Company
possible
Loan Facility
ownership

MLP Concerns and Potential Restructuring Issues

Financing at the Sponsor and General Partner Level

As mentioned above, the MLP structure generally provides the ability to borrow money at various levels in the structure. A lender to the sponsor should be aware that it is common for a sponsor or general partner's credit facility to be arranged so that its MLP and related operating company (if applicable) are exempt from some, if not all, of the restrictive covenants that would typically be included in a parent company's lending documents (such as restrictions on: (i) making distributions or investments; (ii) incurring additional indebtedness or creating liens; (iii) selling substantially all assets; or (iv) engaging in affiliate transactions). This is important to consider when purchasing the debt of a sponsor or general partner because there may be fewer direct operational controls than credit investors are accustomed to relying on.

Another important aspect to consider is whether credit events occurring at the MLP/operating company level trigger rights and remedies available to lenders in a sponsor/general partner level credit facility. Since the creditworthiness of the MLP often correlates with the financial health of the sponsor/general partner, potential lenders to the sponsor or general partner may be concerned if they cannot act upon a default at the MLP/operating company level.

Lenders to a sponsor/general partner should also evaluate whether the sponsor/general partner level debt is contractually or structurally subordinated to debt extended directly to the MLP or the operating company. When undertaking this analysis, it is important to examine the current amount of debt extended to the MLP/operating company, the amount of debt that the MLP or operating company has the ability to obtain in the future and any other material contractual obligations of these entities.

Financing at the MLP and Operating Company Level

The structural concerns of a debt investor at the sponsor and general partner level are, in many aspects, inverse to the concerns of the debt investor at the MLP and operating company level. For instance, lenders to the MLP/operating company will want the MLP/operating company to be exempt from any restrictive covenants contained in the sponsor level lending documents. MLP/operating company lenders will also prefer if any sponsor/general partner level debt is subordinate to their debt.

Drop-down of Assets Into the MLP

A core component of the MLP structure is the "drop-down" of assets into the MLP (or operating company). Although the cash provided to the sponsor in exchange for the dropped down assets will provide the sponsor with short term liquidity, monetizing assets of the sponsor has potential implications on a sponsor's credit profile. Furthermore, since MLPs require a significant amount of cash flow to satisfy their distribution requirements, they (and their sponsors) are less likely to have large cash stockpiles that, in times of stress, would help a company weather difficult financial circumstances.

When analyzing a sponsor, it is important to recognize that future drop downs are possible (and likely). This may result in a situation in which it is difficult to determine the future credit worthiness of the sponsor. It is also important to determine whether the drop down transaction was bona fide and properly implemented from a legal perspective. When a sponsor drops down assets into an MLP (or operating company), it is customary and prudent to seek fairness opinions from independent credible entities regarding the valuation of the assets dropped down to ensure that the drop-down is not viewed as being unreasonable at a later date should the transaction subsequently be the subject of scrutiny in an insolvency proceeding or other litigation.

MLP or Operating Company Bankruptcy

A bankruptcy of an MLP or its operating company may have implications for its sponsor and general partner. It is possible that distributions made from the MLP to the sponsor or general partner prior to bankruptcy could be subject to claw-backs, particularly if proper procedures were not followed. Public investors in an MLP that hold limited partnership units have very little power to exercise control over the management of the MLP (discussed further below). This fact, in the event of a failure of the MLP, could incentivize the public investors to bring lawsuits against the general partner and/or sponsor.

Sponsor Bankruptcy

In the event of a bankruptcy of the sponsor or general partner, a significant issue is whether such sponsor or general partner is able to consolidate the MLP/operating company into the bankruptcy proceedings. An MLP's partnership agreement could attempt to protect against this by providing that consent of a majority of independent directors is required for a voluntary bankruptcy filing of the MLP.

There have been limited recent cases involving sponsors filing for bankruptcy protection. This demonstrates the strength of these entities but also indicates that their structure has not been thoroughly tested in a restructuring context. In one of the few recent cases, *Semcrude, L.P., et al 08-11525(BLS)*, the MLP structure was not the cause of the debtors' liquidity crisis, which resulted in its filing for bankruptcy protection. Inasmuch as in this case the MLP was "rolled back" and substantively consolidated into the sponsor bankruptcy without challenge, little guidance is provided in the decision as to when substantive consolidation on a contested basis may be an issue in the MLP structure.

Corporate Governance

The sponsor of an MLP generally retains 100% ownership of the MLP's general partner and appoints the general partner's board of directors. Although, in theory, the sponsor does not have the legal right to operate or otherwise directly control the MLP, typically in practice, in accordance with the terms of the MLPs partnership agreement, the general partner will have exclusive management control over the MLP (and therefore the sponsor will have indirect control via its appointment of the general partner's directors).

Unlike most other public corporations that are required to have a majority of independent directors, MLPs are only required to have three independent directors. As a result, most MLPs have a majority of nonindependent directors, which could give rise to possible related party transactions (between the general partner/sponsor and the MLP/operating company) that are not subject to sufficient noninterested oversight and unfairly benefit the sponsor/general partner.

Because Delaware limited partnerships are permitted contractually to expand, restrict or eliminate fiduciary duties of directors in their partnership agreements, directors of an MLP may be subject to modified, limited, or eliminated duties of care and loyalty. Investors should be aware that, in addition to potentially having duties to the MLP's creditors and unit holders, the general partner's directors may also have duties to its sponsor.

In addition to typical management issues in a normal restructuring, the factors discussed above may increase the complexity of an MLP restructuring.

As mentioned above, an MLP's governing documents typically require the MLP to distribute 100% of its "available cash" to its equity holders (in part, in order to enable them to pay income tax due on income allocated to them from the MLP, as described below). The definition of "available cash" may vary and should be carefully reviewed. In addition, a sponsor or the general partner usually has the right to receive "incentive distribution rights" (IDRs) from its MLP. IDRs operate as a form of carried interest and provide that the sponsor/general partner has a right to receive an increasing share of cash distributions as certain benchmarks are met. A significant matter to consider is whether the sponsor/general partner has the ability to manipulate the process to extract additional funds from an MLP (especially before cash flow problems are identified).

Internal vs. External Distribution Support

MLP's can utilize two different mechanisms to promote cash distributions: internal support and external support. The more common of the two mechanisms are internal support structures. In this framework the general partner's units in the MLP are subordinate to the other units of the MLP and distributions must be paid to the non-subordinated units before the general partner receives distributions in connection with its subordinated units. By contrast, distribution support mechanisms are referred to as "external" support mechanisms if, instead of having subordinated units, the general partner is able to forego its distributions and in exchange for its forfeiture, the general partner receives additional units in the MLP. When there is an internal support mechanism, it is important for an investor to understand that the MLP's governing documents may provide the general partner with the opportunity to manipulate its subordinated shares and change the terms of such subordination. Investors should be aware that external support mechanisms provide the general partner with the ability to increase its ownership in the MLP, thereby increasing the general partner's voting power, which can be very important in a restructuring scenario.

Tax

As indicated above, MLPs earning "qualifying income" are treated as "pass through" entities for US income tax purposes. As such, the typical oil and gas MLP is not subject to income in its own right; rather the income it generates is allocated to its equity owners. Therefore, if a lender to an MLP is converted into an equity holder in a restructuring, the lender may become subject to US federal (and possibly, state and/or local) income tax on income earned by the MLP. This will be regardless of whether any cash is available for distribution.

The potential adverse US tax consequences to US or non-US lenders who become owners of equity in an MLP can be particularly dramatic in a distressed scenario. A financially stable MLP is able to set-off the taxable income allocated to its equity holders by utilizing tax deductions for depreciation of acquired assets and interest on debt. This is in contrast to a distressed MLP, which in most cases, will have a diminished depreciation shield as it is unlikely to be acquiring new assets that generate accelerated depreciation deductions. In addition, conversions of its debt into equity will eliminate the accrual of deductible interest on such converted debt. Accordingly, a lender that becomes an equity holder is likely to be allocated significant taxable income even if receiving little or no cash in connection with the restructuring of its loan. Moreover, a lender who has become an equity owner before other lenders, *i.e.*, where debt is still outstanding, may also be allocated non-cash "cancellation of indebtedness" income attributable to reductions in, or forgiveness of, such other lenders' debt.

For non-US lenders, the consequences of becoming an equity owner in an MLP can be even more problematic. This is because income generated by ownership of a US MLP is considered "effectively connected" with a US trade or business and, as such, will generally subject non-US investors to direct US federal (and possibly, state and/or local) income tax and tax filing requirements. This applies even if the non-US investor is otherwise not engaged in a US business and not already required to file US income tax returns. As long as the non-US investor has simply been a lender, by contrast, lending from a non-US branch, it would generally not have been required to file US income tax returns and would, generally only have been subject to US withholding tax on interest payments. Moreover, typically any such withholding tax would have been reduced or eliminated pursuant to the terms of an applicable income tax treaty, or, in the case of a non-bank lender, eligible for exemption under the statutory "portfolio interest" from withholding tax provisions of the Code. Finally, under the so-called "FIRPTA" rules, a non-US holder of equity in an MLP likely will be taxed (and required to file US tax returns) with respect to any gain recognized on disposition of its interest. Accordingly, the switch from the status of MLP lender to MLP equity owner can have very significant tax consequences for non-US investors. One method used to address this potential adverse tax consequence is to employ a blocker structure. As there are significant diligence matters associated with the foregoing issues, any restructuring of an MLP will take a significant amount of time and involve participation by corporate, tax and restructuring professionals.

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