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# Master Limited Partnerships (MLPs): A General Primer

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## **Overview**<sup>1</sup>

It has been said that you can't throw a party with net income. In other words, although net income is a nice measure of financial performance, at the end of the day cash is king. That is fundamentally what master limited partnerships (MLPs) are all about: cash (or to be more specific, cash flow). In essence, an MLP is a business enterprise that historically has been measured largely by the stability and predictability of its cash flow. As a tax passthrough entity, the amount of that cash flow is enhanced, as the MLP itself does not pay any federal income taxes. Among other things, this tax savings contributes to the cost of capital advantage enjoyed by MLPs over similarly situated corporations.

### ***An MLP Defined***

So what is an MLP? Simply put, an MLP is a partnership that is publicly traded and listed on a national securities exchange. Breaking those requirements down: first, it is necessary for the MLP to be a state law entity that can be treated as a tax passthrough entity. Thus, most commonly the MLP is formed as a Delaware limited partnership. Increasingly, the MLP may instead be a state law limited liability company — preferably a Delaware limited liability company (an LLC) or even a state law trust, such as a Delaware statutory trust. Although the governance structure may differ among these entity types, any of these entities may be treated as partnerships for federal income tax purposes.<sup>2</sup>

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<sup>1</sup> Some parts of this *Primer* are based on a prior article written by the author entitled "MLP IPO Trends," *Midstream Business Magazine*, Sept. 2011. Reprints of this article are available upon request.

<sup>2</sup> Some MLPs in the shipping and offshore drilling industry are organized as foreign partnerships and are treated as corporations for U.S. tax purposes. The organization and treatment of those types of MLPs are beyond the scope of this *Primer*.

Second, the MLP must be publicly traded. That is, owners of MLP units have the ability to buy and sell interests in the MLP. The publicly traded element of an MLP simply provides for the same type of liquidity (or float) that is enjoyed by a public corporation — although for the most part float and trading volume of MLPs are relatively small compared to the float and trading volume for publicly traded corporations. This is largely because of the nature of MLP unitholders. The majority of MLP units are held, directly or indirectly, by retail investors seeking cash flow. Moreover, given certain tax limitations discussed later in this *Primer*, these investors are typically domestic, rather than foreign. Finally, institutional ownership of MLPs has been limited (although growing in recent years), mainly because MLPs generate income that is not conducive to ownership by tax-exempt investors.

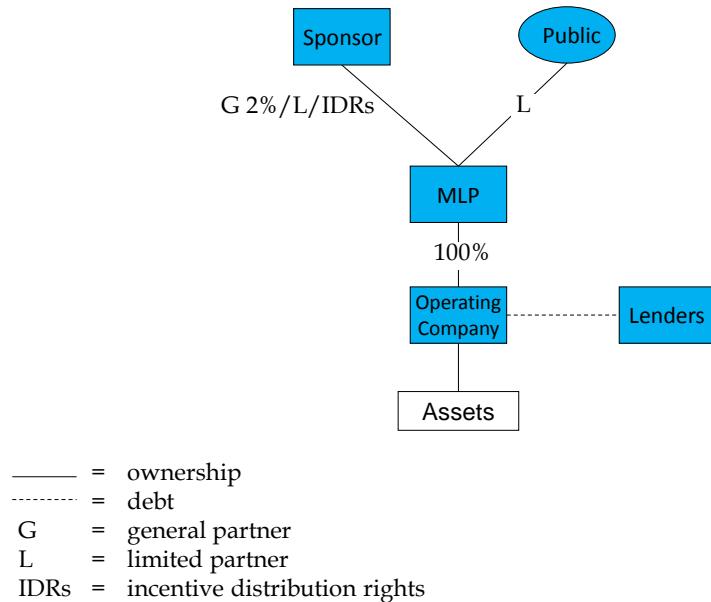
Third, the MLP must be listed on one of the major exchanges. Today, the most common securities exchange for MLPs is the NYSE, although quite a few MLPs are listed on the NASDAQ.

### ***What Does an MLP Look Like?***

An MLP generally has a two-tiered structure. The MLP is the traded limited partnership whose only asset is most commonly its ownership of a wholly-owned LLC or a wholly-owned limited partnership (an LP). In either case, the lower tier entity is known as the “operating” entity. Thus, most MLPs refer to the operating limited liability company (OLLC) or the operating limited partnership (OLP), which we will refer to collectively as the “Operating Company.” The Operating Company will directly or indirectly own the operating assets and other operating subsidiaries of the MLP. Moreover, in many cases, the Operating Company will

incur the debt (depending on credit considerations, the credit facility may instead be at the MLP level).

The ownership of the MLP is split between two primary groups – the public and the “sponsor,” which for purposes of this *Primer* is defined as the overall organization/entity/person responsible for forming the MLP. The public will own some percentage of the MLP, which will vary at the time of the IPO based upon the optimal size of the offering and overall capital structure of the MLP. The sponsor will retain the portion of the MLP not sold to the public, as well as a 2 percent general partner interest in the MLP and a strange and magical thing referred to as “incentive distribution rights” (or IDR<sup>s</sup>).<sup>3</sup> Here is the typical MLP structure one would expect to start with:



<sup>3</sup> Historically, the sponsor owned a 2 percent general partner interest in the MLP. That number can be less at the formation of the MLP in some cases or can be reduced over time through additional equity issuances by the MLP where there is not a “top-up” of the general partner interest by the sponsor, which additional equity issuances results in the dilution of the 2 percent general partner interest.

## ***Why a Two-Tier Structure?***

When seeking answers about why an MLP is structured in a certain way, one will find that many times the answer is “just because it has always been this way.” That is short-hand for “we don’t remember the reason, but that is just what investors now expect.” In the case of the two-tier structure (the MLP and the Operating Company), there were some very good legal reasons in the early 1980s related to state law requirements that a partnership disclose limited partner ownership changes, but those reasons are now largely irrelevant. Today, we retain a two-tier structure for practical reasons. The first is that the structure allows for “double-breasted” financing; that is, the ability to raise debt at both the MLP level and the Operating Company level. Debt raised at the MLP level is then structurally subordinated to the debt at the Operating Company level. The second reason is that the two-tier structure provides for a holding company structure whereby the assets and liabilities of one activity can be isolated from the assets and liabilities of another activity. In other words, the MLP can remain a pure holding entity and all the various businesses and assets can be owned below the Operating Company in multiple operating subsidiaries.

## ***The Economic Structure of the MLP***

The economic structure of an MLP is unique relative to other publicly traded entities. That is because the entire economic structure of an MLP revolves around cash flow. In fact, MLPs are traded based on a multiple of cash flow — not net income. Again, cash is king. As such, an MLP is required (and incentivized) to distribute all of its “available cash” to its unitholders. This requirement to distribute all available cash is a concept found in the MLP’s

partnership agreement. It is not a tax requirement (as contrasted with a REIT, which has a statutory requirement to distribute its income) or securities law requirement. Most partnership agreements require the distribution of all available cash, but that determination is made after the general partner establishes reserves within its discretion. More specifically, “available cash” is commonly defined as all cash on hand during a quarter, less (a) reserves established by the general partner to provide for the proper operation of the business, (b) cash necessary to comply with debt covenants, (c) reserves necessary to provide for distributions for any of the next four quarters and (d) working capital borrowings after the end of a quarter.

This definition clearly gives the general partner wide discretion. Nonetheless, because the MLP is traded based on a multiple of cash flow, the more assurance an investor has that he will receive cash distributions, the greater the market valuation. As a result, most MLPs have utilized some form of cash distribution support.

The most typical cash distribution support mechanism is what is referred to as an “internal” support mechanism, because it is built into the workings and capital structure of the MLP. The limited partner interests that are sold to the public are called “common units” and the sponsor retains a class of equity interests called “subordinated units.” The corporate analog is selling participating preferred stock to the public, while the sponsor retains the common stock. What this means is that the sponsor’s right to cash distributions are subordinated to the right of the public to the same cash distributions. Simply put, the public has to get its cash first before the sponsor receives cash distributions.

In a typical MLP, about one-half of the limited partner interests are subordinated (taking into account the 2 percent general partner interest, this means that 49 percent of the units are

subordinated units and 49 percent of the units are common units). This basically means that there is a 2:1 cash flow coverage for the holders of common units (*i.e.*, the public). Said another way, cash flow at the MLP would have to be cut in half before cash flow to the common unitholders is reduced.<sup>4</sup> Conceptually this means that the public will be willing to pay more for the common units in an IPO as the certainty of cash flow is enhanced.

### ***What is the Quarterly Cash Flow Mechanism?***

In the prospectus filed with the SEC when the MLP is going public, the MLP makes a statement as to its intention to distribute a specified minimum level of distributions on a quarterly basis. This amount of cash flow is referred to as the “minimum quarterly distribution,” or MQD, when an MLP has subordinated units. The common units have a first call on cash distributions to the extent of the MQD. In addition, if there is any shortfall in the payment of the MQD from prior quarters, all arrearages on the MQD must be paid to the common unitholders before any distributions can be made to the subordinated unitholders.<sup>5</sup> Once the common unitholders have received the MQD (and any arrearages), the subordinated unitholders receive the MQD, and thereafter the common unitholders and subordinated unitholders share in cash distributions above the MQD on a pro rata basis.

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<sup>4</sup> In the early years of MLPs, some MLPs contained an “external” cash distribution support mechanism. This mechanism involved the sponsor receiving additional partnership interest (APIs) in return for agreeing to contribute to the MLP additional funds (which were probably funds received by the sponsor at the time the MLP went public) when a shortfall existed to fund the necessary distributions to the common units.

<sup>5</sup> Modern MLPs do not have the concept of arrearages on subordinated units. That concept was last used in the 1980s.

## ***How Long Does the Subordination Period Last?***

Subordinated units can convert to common units, which is an important feature to a sponsor because this conversion mechanism provides a means to monetize the bulk of the sponsor's retained limited partner interests. Historically, the subordination period was five years with an ability to convert the subordinated units into common units early (25 percent after year 3, 25 percent after year 4 and 50 percent after year 5), provided that certain financial tests were met. The financial tests required that the MLP not only have *made* cash distributions to all unitholders (common and subordinated) equal to the MQD for the prior three-year period, but the MLP must have *earned* the distributed cash through operations and not through financings (debt or equity) or asset sales. Within the past several years, many MLPs have reduced the subordination period from five years to three years or even one year and introduced a cliff vesting provision relating to the subordination period. Under this concept, if the MLP is able to earn and distribute 150 percent of its MQD, then after some shorter period (for example, any four consecutive quarters following the IPO), all subordinated units immediately convert to common units. The rationale for this cliff vesting concept is that if the MLP has been able to grow its distribution dramatically, the common unitholders have a large cash buffer and the sponsor has clearly shown that it is able to successfully operate the MLP in a way that the subordinated units are no longer necessary. It is still to be determined whether this rationale is sound in all cases.

## ***The Strange and Magical World of IDRs***

As stated previously, in addition to a 2 percent general partner interest, the sponsor receives an interest referred to as an incentive distribution right (or IDR) at the time of the MLP IPO. Sometimes referred to as the "high splits," the IDR is really a form of carried interest.

Specifically, the IDR is the general partner's right to an increasing share of cash distributions as certain cash distribution benchmarks for the limited partners are achieved. The reason that the IDR contains the word "incentive" is because that right (including the 2 percent general partner interest) grows from 2 percent at inception to 15 percent, then to 25 percent and finally to 50 percent as the cash on cash yield to the IPO limited partners increases. There is obviously a powerful incentive for the general partner to increase the cash distributions paid to the limited partners so that the general partner can enjoy a greater share of those distributions.

The IDRs can also be viewed as a mechanism by which the general partner is compensated for taking a subordinated position in the capital structure at the outset of the MLP. Stated differently, the general partner takes a disproportionate amount of the downside risk at the outset of the MLP and, therefore, the general partner should take a disproportionate share of the upside, too. As to why the downside should be limited in duration but the upside be perpetual – that is one of those answers lost in the sands of time.

Let's assume the following: An IPO investor purchases an MLP common unit for \$20 in the IPO. The MQD is \$0.50 per quarter (or \$2.00 per year). Thus, the target is a 10 percent yield at the time of the IPO based on the MQD. Assume further that the IDR tiers are as follows:

<u>Yield (x)</u>	<u>Limited Partners</u>	<u>General Partner</u>
$x \leq 11.5\%$	98%	2%
$11.5\% < x \leq 12.5\%$	85%	15%
$12.5\% < x \leq 15\%$	75%	25%
$x > 15\%$	50%	50%

Thus, when the distribution per quarter reaches \$0.5750 (or \$2.30 annually), the incremental cash flow above \$0.5750 per quarter is distributed 85 percent to the limited partners and 15

percent to the general partner (as owner of the IDRs). Further, when the distribution per quarter reaches \$0.625 (or \$2.50 annually), the incremental cash flow above \$0.625 per quarter is distributed 75 percent to the limited partners and 25 percent to the general partner (as owner of the IDRs). Finally, when the distribution per quarter reaches \$0.75 (or \$3.00 annually), all incremental cash flow thereafter above \$0.75 is distributed 50 percent to the limited partners and 50 percent to the general partner (as the owner of the IDRs). Grasping this math is a first step in understanding how one reaches the *Forbes* 400 list as an individual sponsor of an MLP.

### **Forming an MLP**

It is almost beyond debate that in the past decade, MLPs have been major contributors to the growth and vibrancy of the capital markets space. That growth has been fueled, in part, by the absolute number of businesses that have been formed or restructured into MLPs. Today, despite continuing market volatility and global economic uncertainties, potential sponsors and the investing public show more interest than ever before in the MLP structure. As a result, MLP initial public offerings (IPOs) are being hotly pursued by both management and their advisors.

To better understand why the interest in MLP IPOs is so robust and to address several aspects involved in the formation of an MLP, it is necessary to take a short walk through the evolution of MLPs.

### ***Early History***

During most of the presidency of Ronald Reagan, no restrictions existed in the tax laws on the types of businesses that MLPs could conduct and operate. Between the first MLP IPO in 1981 (Apache) and 1987, there were more than 100 MLP IPOs. Although the MLP space began

with its attention directed at oil and gas upstream assets, the focus soon shifted to an assortment of operating businesses, many of which had no relationship to oil and gas, or even energy. For example, MLPs were formed around motels (La Quinta Motor Inns Limited Partnership/Aircoa Hotel Partners, L.P.), real estate (National Realty L.P.), amusement parks (Cedar Fair, L.P.), cable television systems (Falcon Cable Systems Company), casinos (Sahara Casino Partners L.P.), and even professional sports (Boston Celtics Limited Partnership). When Congress saw the proliferation of MLPs in the public markets, it enacted legislation intended to severely restrict the types of businesses that could operate as MLPs. Specifically, Congress sought a means to stem the perceived loss of tax revenue from publicly traded partnership vehicles, as MLPs, unlike corporations, do not pay federal income taxes. More specifically, unlike a corporation, which pays taxes on its own income, the income earned by an MLP is passed through to its owners — the public investors. These public investors, in turn, pay the income tax at their individual rates.

### ***Asset Types and Qualifying Income Limitations***

In 1987 when it passed legislation that restricted the use of MLPs, Congress did not necessarily throw all industries under the proverbial bus. Instead, Congress expressly carved out much of the energy industry from the draconian effects of these new rules, thereby preserving the ability of large swaths of the energy industry to operate under the MLP structure. Under this legislation, for an MLP to be taxed as a flow-through entity, at least 90 percent of its gross income for each taxable year must be income that is considered “qualifying income.”<sup>6</sup> If an MLP

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<sup>6</sup> For these purposes, “gross income” means gross revenue before costs for an MLP that provides services. For an MLP that sells products, the tax rules define gross income as sales less cost of goods sold (otherwise known as gross margin to most everyone else in the world).

fails to satisfy this test, the MLP will be taxed as a corporation for federal income tax purposes, thereby eliminating any advantage from operating as an MLP rather than a corporation. These rules are found in section 7704 of the Internal Revenue Code of 1986, as amended, and are many times referred to generally as the “qualifying income rules” or the “7704 rules.”

So what is “qualifying income”? Qualifying income includes, among other things, income and gains derived from the exploration, development, mining or production, processing, refining, transportation (including pipelines transporting gas, oil or products thereof) or the marketing of any mineral or natural resource, as well as certain passive-type income including interest, dividends and real property rents.

For purposes of the qualifying income rule set forth in the tax code, with respect to natural resource-related activities, the term “mineral or natural resource” means fertilizer, geothermal energy and timber, as well as any product from which a deduction is allowable, which includes oil, gas, and oil-and-gas related products. Typically, anything that is dug or pumped out of the ground qualifies, which includes coal, lignite, potash, salt, aggregates, limestone, sand and many other hard rock minerals. Moreover, Congress made it clear in the legislative reports accompanying these qualifying income rules that, for purposes of determining the limits of what constitutes oil, gas, or products thereof, such term includes gasoline, kerosene, number-2 fuel oil, refined lubricating oils, diesel fuel, methane, butane, propane and similar products that are recovered from petroleum refineries or field facilities.

Yet there are limitations. In 1988 Congress clarified the qualifying income rules to provide that there are certain products, such as soil, sod, turf, water, mosses and minerals from seawater, air and other similar inexhaustible sources, that are excluded. Thus, items that are

renewables, such as agricultural products (wheat or corn, for example), or items that are unlimited in supply such as solar power or wind, do not constitute natural resources for these purposes and, therefore, cannot qualify.

Also, in 2008, Congress amended the MLP tax rules to provide that qualifying income includes the storage and transportation of alternative fuels such as biodiesel and ethanol. However, this amendment does not extend to activities beyond storage and transportation. Therefore, the manufacturing or sale of biodiesel or ethanol does not generate qualifying income. Moreover, the 2008 amendment also provided that any income associated with industrial source carbon dioxide generates qualifying income, which includes activities such as transportation and marketing.

For purposes of the midstream sector, as long as the MLP is earning income from the transportation of oil, gas or liquids, that income will be qualifying income. In this context, transportation is interpreted widely, but with some parameters. First, although it appears that any movement of a natural resource or mineral from one place to another will generate qualifying income, Congress seeks to impose limitations on what kinds of transportation would generate qualifying income. In the legislative history to section 7704, Congress indicated that transportation by pipeline of any mineral or natural resource generates qualifying income. On the other hand, the legislative history states that the transportation of oil and gas and products of oil and gas to a retail outlet, other than by pipeline, does not generate qualifying income. As a result, the transportation of oil, gas and products thereof by truck, rail or barge to a retail outlet does not generate qualifying income. For this purpose, the IRS defines retail to include not only traditional retail customers, but also non-energy related industrial and commercial users.

However, the legislative history makes it clear that the transportation of those items to a bulk distribution center, such as a terminal, or to a utility providing power to customers does generate qualifying income. Also, the transportation of gas or other products by pipelines to private residences generates qualifying income for local distribution companies. Managing and operating (but not owning) a pipeline that transports a natural resource also generates qualifying income.

In addition, if the MLP is earning income from the marketing of any mineral or natural resource, that income is generally qualifying income. Nonetheless, just like transportation income, Congress sought to limit the kind of marketing income that would be qualifying income. The legislative history to section 7704 of the Code indicates that, with respect to the marketing of minerals and natural resources, qualifying income does not result “from marketing minerals and natural resources to end users at the retail level.”<sup>7</sup> The IRS has taken the position that any sale of fuel to an end user of the fuel constitutes a retail sale for purposes of the natural resource exception, regardless of the quantity of the sale or the nature of the purchaser, unless the purchaser is involved in otherwise qualifying activities under section 7704 (*e.g.*, an upstream company).

As a result of these generally broad rules permitting many types of energy operations to satisfy the qualifying income test, there have been over 100 energy-related MLPs formed in the past 25 years. The majority of these MLPs are focused on the midstream pipeline sector, but not an insignificant number are focused on upstream, mining, shipping (international and coast-wise), propane, fertilizer, oilfield services and refining.

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<sup>7</sup> S. Rep. No. 445, 100<sup>th</sup> Cong., 2d Sess. 424 (1988).

### ***Other Types of Qualifying Income***

Even if the product (or service) from which an MLP is deriving income is not a mineral or natural resource, the MLP can still generate qualifying income in other ways, as there are several other categories of income that fall under the statutory definition of qualifying income. Those categories include (i) real property income, which includes rents from real property and income from the sale of real property, (ii) interest (but not from an insurance or financial business), (iii) dividends, (iv) gain from commodities, futures, forward and options with respect to commodities and (v) gain from the sale of assets that otherwise generate qualifying income.

### ***Organizational Tax Issues***

The major issue associated with forming an MLP relates to the taxation of formations and related distributions to the sponsor, with the principal issue being whether the sponsor of the MLP will recognize gain for tax purposes upon the formation of the MLP. Usually that determination is driven by the sources and uses of cash in the IPO. There are typically two sources of cash in an MLP — the sale of units to the public and the placement of private or public debt. The largest job for the tax advisors, after the assets are contributed in a tax-free manner under the applicable tax rules, is to determine how the sponsor can take that cash out of the IPO transaction at the outset on a tax deferred basis — which means largely being able to navigate the so-called disguised sale rules and the basis limitation rules contained in the tax code.

Note that, at best, the formation of the MLP is a tax-deferral mechanism for the sponsor, not tax-free. The built-in gain associated with the contributed assets will be recognized by the sponsor over the depreciable or depletable life of those assets by virtue of the application of section 704(c) of the Internal Revenue Code.

This tax-deferral mechanism for the sponsor also impacts the so-called “tax shield” to the public. The market expects the pre-tax return and the after-tax return for an MLP to be almost identical. This means that there is focus at the time of the MLP IPO on the relationship between the amount of cash distribution by an MLP and the amount of taxable income allocated to its common unitholders. The excess of the cash distributed by an MLP over the amount of taxable income allocated to its common unitholders is treated as a return of basis and is not taxable. Stated differently, the shield is nothing more than the reciprocal of the ratio of taxable income to cash distributions. So, for example, if you sell an MLP unit for \$20 with a 10 percent yield and you want an 80 percent shield, then the MLP would distribute \$2.00 in cash but would allocate only \$0.40 in income with the remaining \$1.60 being treated as a return of capital. Most MLPs distribute an amount of cash that far exceeds the amount of taxable income that they allocate to their unitholders.<sup>8</sup>

Ultimately the capital structure of the MLP will have an equity and debt component the ratio of which is driven by market dynamics and discussions between the company and the investment bankers. That ratio of debt to equity in the capital structure many times influences the tax planning for the IPO.

### ***The MLP Investor Base***

As stated at the outset of this *Primer*, the typical MLP investor is a domestic retail investor. That is largely because of certain tax rules that make MLP investments by institutions and foreigners less advantageous. Specifically, the income of an MLP is mostly considered

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<sup>8</sup> Most MLP investment bankers look for a 70–80 percent tax shield for the public in an IPO, which is forecasted for the first several years after an IPO on a cumulative basis.

unrelated business taxable income (or UBTI) to a tax-exempt investor (which also includes IRAs and 401(k) accounts). In other words, tax-exempt investors pay income tax on their allocable share of the MLP's income. For some tax-exempt investors, the generation of UBTI is a non-starter, as they would prefer to sit on the sidelines rather than invest in an entity that generates UBTI, which then triggers a reporting obligation for the tax-exempt entity. Another category of investors for whom the MLP investment is less desirable are non-U.S. persons. Non-U.S. persons will be considered to be engaged in a business in the U.S. because of the ownership of units — “effectively connected income” or “ECI” for the tax people. As a consequence, those unitholders will be required to file federal income tax returns to report their share of the MLP's income, gain, loss and deduction and pay federal income tax at regular rates on their share of net income or gain. To encourage non-U.S. investors to pay taxes on their allocable share of MLP income or gain, the U.S. tax system requires that MLPs withhold on the quarterly gross distributions to foreign unitholders at the highest applicable effective income tax rate, even if the amount of income allocated to the foreign unitholder is substantially less than the actual gross distributions. Finally, mutual funds (or RICs) are limited in their ability to invest in MLPs. The tax rules allow mutual funds to own less than 10 percent of any one MLP, and no more than 25 percent of the value of the mutual fund's total assets can be invested in MLP securities (equity and debt). If either of those tests are failed, the mutual fund will lose its passthrough status for federal income tax purposes, and, therefore, be taxed as a corporation.

### ***Application of Securities Laws to an MLP***

Among the most important issues that we have to deal with and also one of the most cumbersome are timing issues associated complying with federal securities laws. Because the

sponsor is undertaking a public offering in an MLP transaction, the issuer has to satisfy all the disclosure requirements contained in the federal securities laws (specifically, the Securities Act of 1933). This basically means that the sponsor and its advisors have to draft a registration statement that must be filed with the Securities and Exchange Commission (SEC) (the exact SEC form is called an S-1). The process of preparing and filing the registration statement involves the work of the lawyers, investment bankers, accountants and the sponsor, all of whom work together to create the voluminous disclosures.

The Form S-1 is ultimately filed with the SEC, and once the sponsor receives final clearance from the SEC (usually after several rounds of comments), the underwriters and the MLP begin their marketing efforts (called the roadshow), and sell the securities to the public and close the transaction. That entire process (from the initial organizational meeting with the underwriters and their counsel to the closing of the transaction) can take anywhere from four to six months or longer, four being very aggressive and six being more likely. The only period in which the sponsor has real control over timing is the period in which the registration statement is initially prepared and filed with the SEC, which is typically at least a two-month process. Two to three months in SEC review and a couple of weeks for the road show and closing and you can see how we get to a four- to six-month IPO timeline.

Finally, after the IPO, the MLP itself will be subject to the requirements of the Securities Exchange Act of 1934, which requires periodic reporting with the SEC. Although this typically will not include an annual proxy statement, as there is no need to conduct an annual meeting to elect directors because the directors are appointed by the sponsor, it does mean that the MLP will

have to file an annual report on Form 10-K, quarterly reports on Form 10-Qs and various categories of current information on Form 8-K.

### ***Governance of MLPs***

MLPs are unique in their governance. As described above, in an MLP that is organized as a limited partnership, the general partner of the MLP (the GP) is typically a Delaware LLC. The GP will have executive officers and a board of directors that will manage the business and affairs of the MLP. The sponsor will own 100 percent of the GP (which translates into 2 percent of the units outstanding) and will appoint the members of the GP's board of directors. At the time of the IPO, the sponsor will also own a majority of the total limited partner interests (all of the subordinated units (49 percent of the units outstanding) and a minority of the common units (those common units not sold in the IPO)). In turn, the public will own a minority of the total limited partner interests, but a majority of the common units.

Under the MLP's partnership agreement, the GP has exclusive management powers over the business and affairs of the MLP. Although the sponsor will control the MLP in a general sense, the sponsor will have no legal right to operate or otherwise directly control the MLP or its assets. The only legal rights that the sponsor will have with respect to MLP governance will be (i) the right, through its ownership of the GP, to elect the members of the GP's board of directors, who, in turn, elect the officers of the GP and (ii) the right to vote its common units and subordinated units in any matter requiring unitholder approval in accordance with the MLP's partnership agreement. As for the board of directors, unlike a public corporation that has to have a majority of independent directors, an MLP is only required to have three independent directors who are qualified to serve on the board's audit committee. There is no limit to the number of

non-independent directors who can be appointed by the sponsor, which means that most MLPs have at least a majority of non-independent directors.

### ***Accounting for MLPs***

Accounting for MLP formation transactions is an occupation best left for the professionals. Nonetheless, a couple of very general observations can be made. First, at formation it is likely that a sponsor will continue to consolidate the MLP. In fact, consolidation is generally the rule as long as the sponsor owns the MLP's general partner interest. This remains true regardless of the percentage of limited partner interests in the MLP retained by the sponsor in the future. Second, it is unlikely that the IPO will result in book gain to the sponsor. Notwithstanding the foregoing observations, it is always best to talk to the accounting experts regarding the accounting treatment for MLPs.

### ***Industry and Overall Market Trends***

During the first two decades of the post-1987 rules for MLPs, one could expect two or three new MLP IPOs per year. During that period, current MLPs such as Ferrellgas Partners, L.P. (1994), Suburban Propane Partners, L.P. (1996) and Enterprise Product Partners L.P. (1998) were formed. In 2002, the IPO market for new MLP issuers accelerated with the successful completion of six new MLPs. Other than a blip in 2003 with the absence of any new MLP IPOs, that robust level of new issuances continued unabated until the general economic slowdown of 2008 and 2009. For example, from 2004 through 2008, more than 30 energy-related MLP IPOs were completed. During this period, an additional 10 MLP general partners were taken public. The energy-related industries represented in this dash to raise public equity included upstream, midstream (gathering/processing/interstate transportation/storage), shipping, refining and oilfield

services (compression). In other words, the entire oil and gas value chain was represented in offerings during this period.

Between mid-2008 and mid-2010, during the recession, the MLP IPO market was shut down. Nonetheless, in the spring of 2010 the current MLP IPO process once again rebounded, and since then the market has returned with great gusto with the successful completion of more than 20 additional MLP IPOs, which included MLPs focused on coal, fertilizer, upstream oil and gas, international shipping, compression and midstream logistics.

Given this wide variety of businesses going public in the MLP space, one might conclude that the public is seemingly less concerned with the type of asset contained in the MLP than they have been in the past. Now, investors are focused on predictability, stability of cash flow and yield. In today's interest rate environment when the 10-year U.S. Treasury is trading at historically low levels, the average yield-seeking institutional investor, and particularly the average individual yield investor, is hard pressed to find ways to earn yield-based returns substantially in excess of rates a bank will pay for savings accounts. MLPs are perceived, and rightly so, as an instrument where the investor can earn a strong quarterly yield-based return, and also retain the potential for capital appreciation. Because there are very few other investment opportunities that offer those types of dual benefits, the MLP sector has seen a tremendous increase in investor appetite for these new IPO issuances.

### ***Tips for Success***

If a sponsor entity is interested in either converting itself into an MLP or contributing assets to a newly formed MLP, there are several important features that should be addressed. First, it is absolutely critical that the financial statements with respect to the MLP business be addressed early in the IPO process. Ultimately, the IPO registrant will have to provide, among other things, three years of audited financials.<sup>9</sup> Depending on the factual predicate for the assets that constitute the MLP, this exercise may result in a long lead time for the IPO process, especially when the assets are being carved out of an existing business and have not been the subject of any previous audits.

Also, although it is critical that the business of the MLP qualify under the tax rules described above, it is equally critical that the business is one that is appropriate for an MLP. In other words, the MLP's business should be one that generally entails stable and predictable cash flow, as the MLP is traded on the basis of cash flow and yield, rather than net income. Notwithstanding this general rule, there are several new MLPs that have abandoned the concept of minimum quarterly distributions and have instead embraced the proposition that the operating business is a commodities business that is cyclical in nature. Therefore, the MLP investor should expect greater cash returns when the prices of the commodities that are the subject of the MLP are high and diminished cash returns when the prices of the commodities are low. These so-called "variable MLPs" are a major deviation from the historic practice of MLPs, but given their limited use currently (primarily for fertilizer and refinery MLPs at this point), the overall market impact of this variable or floating distribution structure may be limited.

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<sup>9</sup> This requirement may be limited to only two years of audited financials if the MLP qualifies as an emerging growth company under the JOBS Act, which became law in April 2012.

Another important timing issue relates to management. The executive management team should be in place at the time the IPO process begins because this team must represent the business during the IPO process and be the face of the MLP to the public. Often, the new MLP business is only a part of a much larger enterprise. In that case, it is common for the MLP to search for a dedicated chief executive officer, even if many of the MLP functions are serviced by existing sponsor employees.

Finally, there is no substitute for preparation and organization in the IPO process. The more upfront work done on the business plan, operations, financial models, tax structuring, accounting and the coordination of the right team of advisors, the more efficient the process will be.

### **Conclusion**

Going forward — and although the macro-economic signs are uncertain — one should expect continuing and robust activity in the MLP space, absent major constraints in the capital markets. MLP sponsors perceive that the MLP structure offers a cost of capital advantage over similarly situated public corporations, in part due to the MLP's efficient capital structure that eliminates entity-layer federal income taxes. Investors view the MLP as both an opportunity for a superior yield relative to other investment choices, as well as a growth play. As in most years, that activity will be led by new companies taking advantage of the MLP as a means of operating in a more efficient and profitable manner.

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