LAW360

Portfolio Media. Inc. | 860 Broadway, 6th Floor | New York, NY 10003 | www.law360.com
Phone: +1 646 783 7100 | Fax: +1 646 783 7161 | customerservice@law360.com

How To Structure A HoldCo Loan In The Energy Industry

Law360, New York (March 26, 2013, 9:50 AM ET) -- Recent months have seen an increasing number of credit facilities that are designed to provide capital to a holding company (HoldCo) sitting above a master limited partnership (MLP), joint venture (JV) or other energy-related operating company (OpCo). These facilities are sometimes referred to as "Holdco Loans."

The capital that is provided may be used to make a distribution to a sponsor, invest in the OpCo, acquire and develop assets that in the future may be transferred to the OpCo, for working capital or a combination of all of these. The facilities may include a revolving credit facility, a term loan (term loan A or B) or both. The reason for the uptick in these facilities is twofold — the robust oil and gas economy is driving demand for these facilities, and the facilities are available on terms that make economic sense for many borrowers and sponsors.

Structuring such a transaction, whether on behalf of a financial institution or a borrower/sponsor, will inevitably bring certain key issues into the forefront. These include:

Security

Depending on the creditworthiness of the sponsor, borrower and the OpCo, these facilities may range from unsecured credits (with the less restrictive provisions generally associated with such facilities) to highly structured credits with elements that are reminiscent of nonrecourse project finance. When the deals are secured, they are generally secured by the assets of the HoldCo or affiliated group of holding companies, and not the assets of the OpCo or the ultimate sponsor.

With some exceptions, the most important collateral will be the equity of the OpCo owned by the holding company group. It is important for the parties to recognize that the pledge of that equity may be restricted, and if so, those restrictions either will have to be reworked or respected. For example, the organizational documents of an MLP will likely restrict the direct pledge of the general partner interests in the MLP and possibly the incentive distribution rights (IDRs).

The organizational documents of a JV OpCo may contain myriad transfer restrictions, which could affect either the granting of a security interest in the equity interests of the JV OpCo, the enforcement of remedies by the secured parties in the pledged equity interest, or both. At an early stage of the structuring, diligence should be completed to identify precisely what collateral is available and at what level of the structure.

Margin Regulations

Many Holdco Loans will involve the pledge of publicly traded equity, but (with exceptions) are not intended to be used to actually fund the acquisition of publicly traded equity. It would be tempting in many cases to stop there in the structuring analysis — to simply determine that the loan is not being made "for the purpose, whether immediate, incidental or ultimately, of buying or carrying margin stock."

However, the margin regulations are nuanced, and even in situations where margin stock is not being purchased immediately with the proceeds of the loan, a working capital facility may allow for margin stock to be purchased in the future. And there are certainly credit facilities that are designed specifically to be used to purchase publicly held equity and even could be used to purchase public companies in their entirety. For these reasons, an expert in margin regulations should be consulted on virtually every Holdco Loan.

MLP Tax and Governance Issues

The structuring of an MLP always starts with tax advice, and leveraging a HoldCo above an MLP should be no different. It is important that the significant tax planning that went into the formation of the MLP and its ongoing operations is not disrupted by the Holdco Loan or, if it is affected in any way, that the consequences are fully understood.

The structure should be evaluated by an expert in MLP structures generally in order to determine whether it conflicts with any existing arrangements or any transactions that the borrower may desire to enter into in the future. If the Holdco Loan is being funded into a structure that does not currently include an MLP but may support an MLP offering in the future, MLP tax and governance advice becomes even more important.

Interaction Between Holdco Loan and Opco Debt

One of the most commonly negotiated aspects of a Holdco Loan is whether, and to what extent, events occurring at the OpCo will affect the rights and remedies of the lenders under the Holdco Loan. The sponsor / borrower will typically want the Holdco Loan to stand on its own as much as possible. Lenders seeking a greater degree of protection will want a more direct impact on the Holdco Loan when a negative event occurs at the OpCo.

Where the negotiation settles will ultimately determine how much time will lapse between a problem occurring at the revenue generating OpCo and the point at which the HoldCo lenders will have a seat at the table (particularly significant in a workout or bankruptcy). It is also worth noting that in situations when the HoldCo does not control the OpCo, the financing documentation may rely less on covenants (i.e., provisions that require the HoldCo to cause or prevent the taking of a certain action) and more on events of default.

Structural Subordination

A related point is the extent to which the Holdco Loan is structurally subordinated to debt at the OpCo; in particular, the amount of debt to which it is structurally subordinated. Determining how much debt is outstanding and how much of that debt is secured is straightforward. It is often a more complicated analysis to determine how much debt the OpCo could have, and the nature of that debt, in the future. The restrictions that govern OpCo leverage in effect today may not be the same going forward, as the OpCo debt is amended, refinanced or replaced. Whether the Holdco Loan contains direct restrictions on the amount of debt at the OpCo varies from deal to deal.

Financial Covenants

Similar to a situation in which an OpCo owns an interest in an entity that is not a subsidiary or is an unrestricted subsidiary, the HoldCo will likely receive EBITDA or cash flow credit for purposes of financial metrics only when cash is actually received by the HoldCo from the OpCo. This results in some interesting issues, particularly relating to the pro forma effect of acquisitions or sales, including equity, and annualization of EBITDA or cash flow from acquired equity.

The parties must very carefully consider the impact of pro forma and annualization concepts from the inception of the loan through any future acquisitions, sales and drop downs (see below) to make sure the financial ratios work as the parties intended.

Warehousing Assets, Drop Downs and Disposition of OpCo Equity

Holdco Loans may be used to acquire assets that are subsequently further developed and then "dropped down" into the OpCo when the assets reach a certain completion point. This is particularly the case in the context of an MLP.

From the lenders' perspective, the drop down will change their credit position with respect to those assets from, typically, a direct lien on such assets, to a lien on only the equity interests of the entity that owns those assets (in the case of an MLP or JV it will be less than all of the outstanding equity interests). The terms of permitted drop downs are often negotiated. Whether and to what extent the HoldCo is permitted to sell OpCo equity interests is another issue for negotiation.

Cash Control

Whether deposit and securities accounts are subject to a perfected security interest in favor of the lenders is an important question in any leveraged financing. In the context of a Holdco Loan, maintaining control of the cash flow is even more important.

Depending upon the nature of the Holdco Loan and the creditworthiness of the borrower, the documents may contain a project finance-style cash waterfall intended to ensure that use of cash by the HoldCo is subject to specific parameters and a certain order. This is true whether the HoldCo is developing project-like assets or not.

In a situation where the HoldCo is developing project assets, these provisions will receive even more attention. It would be possible in such circumstances to include other project financing terms and techniques (counterparty consents, monitoring by an independent engineer, cash reserves and so forth) into the terms of the credit facility.

Distributions from OpCo Entity

The due diligence process for a Holdco Loan has much in common with any diligence exercise, including the focus on liability and risk. But the diligence process in a Holdco Loan will focus on one issue to a much larger degree — the ability of the OpCo to distribute its cash to the HoldCo.

In the MLP context, this will require a thorough understanding of available cash, both legally and from a modeling perspective, and also any agreements that may constrain distribution restrictions (credit facilities and high yield bond indentures tend to contain different distribution tests for an MLP).

In a JV context, the organizational documents may contain any number of restrictions on distributions, including permitting a counterparty that is unaffiliated with the HoldCo to have an approval right over distributions. As noted above, the documents at the OpCo cannot be looked at as static; what governs those distributions today may change tomorrow. The parties to a Holdco Loan will typically negotiate the extent of any restrictions on amending the organizational documents of the OpCo, including amending provisions governing distributions.

Other issues may arise in any particular Holdco Loan, and issues that appear in more typical leveraged financings will arise in Holdco Loans as well (such as bankruptcy considerations relating to dividend recapitalizations).

Holdco Loans have been gaining increasing traction in the energy industry as the acquisition and development of oil and gas assets continues at a historic pace, and borrowers and sponsors recognize that financing at a HoldCo level may be available. While these financings have some terms that are common to any financing, certain structuring issues are unique to, or should receive greater emphasis in, structuring and documenting an energy company Holdco Loan.

--By Craig S. Kornreich and Michele O. Penzer, Latham & Watkins LLP

Craig Kornreich is a partner in Latham & Watkins' Houston and New York offices and serves as chairman of the firm's finance department in Houston. He represents arrangers and borrowers in syndicated financings with particular expertise in master limited partnership financings, sponsor-backed acquisition financings, asset-based lending facilities, reserve-based lending facilities, first and second lien financings and project financings.

Michele Penzer is a partner in Latham & Watkins' New York office and is global co-chairwoman of the firm's banking practice. Her practice focuses primarily on the representation of commercial and investment banks, as well as borrowers and issuers, in leveraged finance transactions, including acquisition financings, project financings, other senior secured lending transactions and restructurings.

The opinions expressed are those of the authors and do not necessarily reflect the views of the firm, its clients, or Portfolio Media Inc., or any of its or their respective affiliates. This article is for general information purposes and is not intended to be and should not be taken as legal advice.

All Content © 2003-2013, Portfolio Media, Inc.