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Master Limited Partnership (MLP) Sponsorship by High-Yield Debt Issuers

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If your company is considering raising capital by issuing high-yield notes and, at some later date, sponsoring a master limited partnership, you need to plan ahead to prevent the high-yield debt covenant package from limiting your MLP plans. Failure to think carefully about the constraints imposed by your high-yield debt covenants can make the formation of an MLP unworkable, or at the very least cumbersome and expensive.

A sponsor seeking to monetize MLP qualifying assets and potentially achieve a lower cost of capital for a portion of its business would typically first contribute or "drop-down" those assets into a newly formed subsidiary organized as a limited partnership or limited liability company. The subsidiary and its business are carefully structured to achieve special federal tax treatment afforded to partnerships (no entity-level tax). This new entity then becomes an MLP by conducting an initial public offering of its common equity interests, called common units, in order to achieve the liquidity and valuation of a publicly-traded security for its sponsor and its new equity investors.

Customarily, sponsors design MLPs to maintain some level of financial independence, and perhaps even fashion them with a view toward complete separation. Accordingly, an MLP will often arrange its own bank credit facility at inception (*i.e.*, upon its IPO), and later incur additional debt or refinance the debt incurred under the credit facility by issuing its own debt securities.

Like any other business lenders, the creditors of an MLP will impose restrictive covenants intended to decrease the likelihood of a credit impairment at the MLP. These creditors take a dim view of the MLP being subject to complex restrictive covenants that protect the interests of another constituency, such as creditors of the MLP sponsor. Consequently, arrangements are made to exempt the MLP from its sponsor's restrictive debt covenants. In the world of high-yield debt, this means that the MLP will almost certainly be designated an "unrestricted subsidiary" under the indenture governing its parent's high-yield notes, since modern high-yield restrictive covenants apply only to the note issuer and its*restricted* subsidiaries, as opposed to the issuer and all its subsidiaries.

Although designation of the MLP as an unrestricted subsidiary will be necessary in order to facilitate the arrangement of the MLP's debt facilities, as an unrestricted subsidiary the MLP will not be consolidated with the sponsor for purposes of testing the sponsor's financial performance as measured by the restricted payments and debt incurrence covenants of the sponsor's high-yield notes indenture. Consequently, the financial performance of the MLP will not contribute to the sponsor's financial performance as measured by those covenants, except to the extent of cash distributions that the sponsor receives from the MLP. Of greater concern, however, is the potential toll extracted for moving the assets into the MLP in the first place. The same issue potentially arises each time the sponsor drops additional assets into the MLP, and is discussed below under "Restricted Payments."

Customary restrictive covenants governing high-yield notes are designed to afford investors several protections against the issuer engaging in activities that would be detrimental to its overall creditworthiness. Typically, these restrictions include limiting the issuer's ability to pay dividends or make investments, incur additional indebtedness, create liens, sell or transfer assets, enter into agreements that restrict dividend payments by subsidiaries, engage in transactions with affiliates, or merge or transfer all or substantially all of the issuer's assets. Inasmuch as moving the business and assets of an MLP "outside the credit" of the sponsor, and therefore beyond the restrictions of a sponsor's high-yield debt covenants, generally weakens the creditor protections imposed by those covenants, it is not surprising that each of these covenants has potential application to sponsorship of an MLP. Let's briefly consider each of them.

***Restricted Payments*.** The restricted payments covenant restricts the issuer's ability to pay dividends, repurchase equity and make similar payments. The covenant also restricts the issuer's ability to make investments "outside the credit," by generally limiting the ability of the issuer to make investments in entities that are not restricted subsidiaries under the indenture. These dividends, quasi-dividends and investments are called "restricted payments." The restriction on paying dividends has potential application to an MLP, since an MLP will be expected by its investors to pay regular quarterly distributions. However, since the MLP will be designated as an unrestricted subsidiary, the sponsor's restricted payments covenant will not apply to the MLP's ability to make those distributions.

The more difficult issue under the sponsor's restricted payments covenant is the sponsor's ability to make investments in the MLP. When a sponsor places assets in an MLP, the sponsor will receive or hold common units of the MLP. This will occur upon formation and maybe again in connection with each subsequent asset drop-down from the sponsor to the MLP. Since the MLP will be an unrestricted subsidiary under the indenture, high-yield creditors would generally expect the sponsor's investment in the MLP to be throttled by the restricted payments covenant. The investment is "outside the credit" of the sponsor and its restricted subsidiaries and, absent carefully crafted provisions in the restricted payments covenant, will probably be allowed only to the extent that the sponsor has accumulated sufficient restricted payment capacity. Customarily, this capacity starts at zero for a debut high-yield notes issuer, increases over time with half the issuer's net income, and decreases by 100% of its net losses and its prior restricted payments.

Consequently, unless an MLP sponsor includes special provisions in its high-yield notes indenture, insufficient restricted payment capacity may limit or prohibit the investment in the MLP. In our experience, this issue can be addressed through an item in the list of "permitted investments" an issuer may make despite the investment restrictions of the restricted payments covenant. The manner and specificity of addressing the permitted investment in an MLP varies, as does the degree to which the investment is allowed. Some rather generally worded provisions may open up the possibility of contributing assets to an MLP in amounts that are not limited by the restricted payments covenant, while other more specifically worded provisions may allow the investment to be made only in compliance with a financial ratio. In any event, if the investment issue is not addressed, a high-yield debt issuer aspiring to sponsor an MLP may be stuck needing relief from its noteholders in order to proceed with the formation and IPO of the MLP, and the sponsor may conclude that such relief, through a consent solicitation, would either be impossible or too expensive to obtain without completely refinancing the notes.

***Debt Incurrence*.** The debt incurrence covenant restricts the ability of the issuer and its restricted subsidiaries to incur debt. Generally, in order for an issuer of high-yield notes to incur debt, the issuer will need to pass a financial ratio test (usually a fixed charge coverage ratio) on a pro forma basis, or fit the debt incurrence into one of a list of items called "permitted debt." Although an MLP will likely need to borrow funds, the sponsor's high-yield indenture should not impede the MLP's ability to do so, as long as the sponsor designates the MLP to be an unrestricted subsidiary under the indenture and the MLP incurs its debt on a basis that is non-recourse to the sponsor.

***Liens*.** The liens covenant restricts the ability of the issuer and its restricted subsidiaries to use their assets, including equity of the issuer's subsidiaries, as security for debt, and such covenant might also restrict their ability to have other liens on those assets. As an unrestricted subsidiary under the indenture governing the sponsor's high-yield notes, the MLP should not be subject to the liens covenant in the indenture. However, an MLP sponsor should confirm that the indenture does not prohibit the sponsor from pledging its equity in the MLP to secure the MLP's debt, since bank lenders may require that pledge as part of the terms of lending to the MLP.

***Asset Sales*.** The asset sale covenant imposes certain restrictions on the ability of the issuer and its restricted subsidiaries to sell or transfer assets, especially their ability to sell or transfer assets for non-cash consideration. As an unrestricted subsidiary under the indenture governing the sponsor's high-yield notes, the MLP will not be subject to the asset sale covenant in the sponsor's indenture. However, this covenant could apply to transfers of assets by the sponsor to the MLP, whether as contributions in exchange for common units of the MLP or sales to the MLP for cash. One way to avoid this complication is to make sure that any transaction constituting a permitted investment as discussed above under "Restricted Payments" is defined not to be an asset sale, and consequently is exempt from the asset sale covenant.

***Dividend Blockers*.** Indentures governing high-yield notes almost always include a covenant restricting the issuer's ability to allow restrictions on the ability of its restricted subsidiaries to pay dividends. This covenant provides yet another reason that an MLP sponsor would want to designate its MLP subsidiary as an unrestricted subsidiary, since the MLP's debt instruments, including its bank credit facility, will almost certainly contain such restrictions.

***Affiliate Transactions*.** The affiliate transactions covenant restricts the ability of the issuer and its restricted subsidiaries to engage in transactions with certain other affiliates. Although these restrictions are rarely insurmountable, they can be quite cumbersome and compliance can be expensive, particularly where a fairness opinion is required. Since a sponsor or its restricted subsidiaries will likely engage in repeated transactions with the MLP (*e.g.*, dropping down assets to the MLP), this covenant should be drafted in a manner so as to allow those transactions to occur without imposing undue expense or burden on the sponsor.

***Merger or Sale of Substantially All Assets*.** Indentures governing high-yield notes always include provisions requiring the assumption of the obligations under the high-yield notes and the indenture by an entity with which the issuer merges or to which the issuer transfers all or substantially all of its assets. Although the phrase "all or substantially all" is not clearly defined in applicable law, a particularly large investment in the MLP would warrant a careful examination of whether this threshold would be crossed, since a requirement for the MLP to assume its sponsor’s high-yield debt must be avoided.

Finally, sponsors should keep in mind that there may also be other complex issues posed by the interplay between their high-yield debt covenants and MLP sponsorship, and thorough analysis of a sponsor’s particular plans and indenture terms should occur before, rather than after, issuing high-yield notes. A tenet of high-yield debt practitioners is that high-yield covenants should be drafted with the goal of avoiding the need to ever seek an amendment or waiver, since they can be costly, time consuming and sometimes even impossible to obtain. With some careful planning, that goal can be achieved.

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