MASTER LIMITED PARTNERSHIPS' COST OF CAPITAL CONUNDRUM

Matthew J. McCabe*

INTRODUCTION

Master limited partnerships ("MLPs") are little-known entity types that are growing at a prolific rate in the United States as a result of the ongoing "shale boom" being experienced in Texas, North Dakota, Wyoming, and Pennsylvania.[1] As of February 1, 2014, there were at least

* J.D. Candidate, University of Pennsylvania Law School, 2015; B.A., Kinesiology, Rice University, 2008. The author thanks Professor William Bratton for his support and insightful comments in developing this Comment, as well as Bryn Sappington, Scarlet McNellie, Matthew DeArman, and Benjamin Ratliff of Norton Rose Fulbright for their helpful input. He also thanks the members of the University of Pennsylvania Journal of Business Law for their editorial assistance in preparing this Comment for publication. Finally, he wishes to thank his lovely wife, Kristen, for her unconditional love and encouragement.

1. *See, e.g.*, Matthew Rocco, *U.S. Shale Boom Drives Record Oil-Related Exports*, FOX BUSINESS (Jan. 9, 2014), http://www.foxbusiness.com/industries/2014/01/09/us-shale-boom-drives-refined-product-exports/ (explaining the positive effect that access to "lower-cost crude from shale plays like Eagle Ford in Texas and North Dakota's Bakken" has had on domestic refiners and U.S. exports); Ken Silverstein, *Shale Gas Boom at 'Tip of*

127 of these publicly traded energy partnerships with a market capitalization of about $445 billion.[2] Proving this point, as reported by an October 2013 article in *The Economist*, MLPs accounted for an astounding twenty eight percent of the equity raised among listed companies in 2012.[3] The article referred to MLPs as one of multiple entity types considered to be a "distorporation," or those entities qualifying as pass-throughs for tax purposes.[4]

The need for infrastructure growth in the wake of the shale boom and the accessibility to capital markets which MLPs provide make MLP governance a hot-button topic. Certainly, the most attractive characteristic about MLPs to investors is also the most important one for growing the entities' asset bases — pass-through taxation. MLPs' avoidance of entity-level taxation gives them a competitive advantage over C Corporations in that they can afford to pay a higher price for acquisitions or may realize greater net cash flow from an acquisition at the same price due to their reduced tax burden.[5] However, to exploit this advantage, MLPs must have access to affordable capital.

To summarize, the purpose of this Comment is to answer two questions: (1) Is the conventional MLP governance structure still the most appropriate form for publicly-traded energy partnerships in scope of cost of capital concerns?; and (2) What is the ideal method of keeping MLPs' cost of capital competitive such that they remain attractive investment vehicles for equity investors and maintain their steady growth for pre-existing interest holders? Considering the foregoing interrogatories, this Comment

Iceberg,' Forbes (Oct. 30, 2013, 7:55 AM), http://onforb.es/17wPrtd (asserting that the Marcellus Shale in Pennsylvania "accounts for three-fourths of the growth in the nation's production.").

2. *See* MLP Screener, Alerian, http://www.alerian.com/wp-content/uploads/Energy-MLP-Universe.xls (last visited Mar. 10, 2014) (providing a list of the "Energy Publicly Traded Partnership Universe" as of February 1, 2014); Wells Fargo Securities MLP Primer Fifth Edition: A Guide to Everything MLP – Oct. 31, 2013, Nat'l Ass'n of Publicly Traded P'ships, at 31, *available at* http://www.naptp.org/documentlinks/Investor_Relations/WF_MLP_Primer_V.pdf [hereinafter Wells Fargo MLP Primer] (detailing the investment considerations to be made when considering MLPs).

3. The *New American Capitalism: Rise of the Distorporation*, The Economist, Oct. 26, 2013, at 29 [hereinafter *Distorporation*] (describing the rise of MLPs, Real Estate Investment Trusts (REITs), Regulated Investment Companies (RICs), and Business Development Companies (BDCs) as alternatives to C corporations and these entities' ability to channel capital more aptly to wealth-generating assets).

4. *See id.* (stating that "[T]he American government has in the past restricted the use of such structures. But these restrictions have eased, and more and more businesses are now twisting themselves into forms that allow them to qualify as pass-throughs. The corporation is becoming the distorporation.").

5. *See* Wells Fargo MLP Primer, *supra* note 2, at 23 (discussing the benefits to the sponsor of creating an MLP).

will suggest that conventional MLP governance remains the appropriate form and, finally, that voluntary reduction of Incentive Distribution Rights ("IDRs") by the general partner to accommodate capital expenditures or acquisitions is the optimal method of keeping cost of capital competitive for growth purposes. In exploring this interrelation between an MLP's governance structure and cost of capital, this Comment will also conclude that the recent forays into alternative entity types, alternative partnership management, and variable distributions are admirable experiments, but inadequate substitutes for the "sponsored" MLP model.

The Comment will begin in Part I with an overview of the conventional MLP model. After providing a brief history of MLPs in Part I(A), an explanation of conventional MLP formation and structure will follow in Parts I(B) and I(C), detailing the unique facets of the entity that affect its cost of capital. In Part II, this Comment will build upon the MLP framework described in Part I by analyzing the cost of capital implications that stem from conventional MLP governance. This analysis will begin in Part II(A) with an examination of incentive distribution rights ("IDRs") and their effect on cost of capital.[6] Then, the Comment's focus will turn in Part II(B) to the ability of the conventional MLP model to adapt to rising cost of capital, often caused by "high splits" in the IDRs.[7] Part II(C) will argue that contractual methods of addressing cost of capital concerns are appropriate. This portion of the Comment will also serve as a review of the theory of "uncorporation" promulgated by alternative-entity supporter and noted "contractarian" Larry Ribstein.[8]

I. CONVENTIONAL MLP GOVERNANCE

A master limited partnership ("MLP") is a limited partnership whose limited partnership interests are publicly-traded and referred to as

6. For an explanation of IDRs, *see infra* notes 50–66 and accompanying text.
7. *See infra* notes 64–66 and accompanying text (defining high splits).
8. *See, e.g.*, Larry Ribstein, *The Uncorporation's Domain*, 55 VILL. L. REV. 125 (2010) [hereinafter Ribstein, *Uncorporation*] (describing the ongoing competition between corporations and "uncorporate" business forms such as partnerships, limited partnerships, and limited liability companies, and the businesses appropriate for "uncorporate" form); Larry Ribstein, *Partnership Governance of Large Firms*, 76 U. CHI. L. REV. 289 (2009) [hereinafter Ribstein, *Partnership Governance*] (examining private equity firms among other "uncorporate" structures and how these entities align the interests of interest holders with management); Larry Ribstein, *Fiduciary Duties and Limited Partnership Agreements*, 37 SUFFOLK U. L. REV. 927 (2004) (discussing the restrictions on fiduciary duties waivers in limited partnership agreements of the Uniform Limited Partnership Act); Larry Ribstein, *An Applied Theory of Limited Partnership*, 37 EMORY L.J. 835 (1988) (asserting the economic benefits of organization as a limited partnership and the appropriateness of a different method of taxation for partnerships versus C corporations).

"common units," which are analogous to common stock in C corporations.[9] The major difference, however, is that C corporations are subject to "double taxation" by which the entity pays corporate taxes and the stockholders pay taxes on dividends, whereas MLPs are exempt from entity-level taxation and, as result, pass on all deductions along with the taxable income allocable to each unitholder.[10] It is this characteristic that makes holding MLPs attractive to investors, especially those seeking to hold assets with high yields and high growth, but capable of shielding them from a yearly tax burden.[11]

A. Origins

MLPs emerged in the early 1980s, coinciding with the end of widespread conglomeration and the advent of the leveraged buyout and bust-up of the mid-1980s.[12] It is widely believed that the first MLP came about in 1981 when Apache Petroleum Corporation combined thirty drilling and exploration limited partnerships into one "master" limited partnership.[13] To consummate the transaction, each of the individual limited partnerships contributed all of their interests into the MLP in exchange for limited partnership interests in the MLP — also called a "roll up."[14] Nowadays, MLPs are typically formed through either "rollout" or "acquisition" transactions.[15]

Though in the beginning MLPs primarily held oil and gas assets, by 1987 nationally known brands like Burger King and the Boston Celtics had reorganized as MLPs, providing the impetus for legislative change.[16] The Revenue Act of 1987[17] was a major lawmaking development that limited the entity-level taxation exemption to only those publicly traded

9. *See* John Goodgame, *Master Limited Partnership Governance*, 60 Bus. Law. 471, 471 (2005) (providing a definitional overview of MLPs).

10. *Id.* at 472.

11. *Id.* at 474.

12. *See* Donna D. Adler, *Master Limited Partnerships*, 40 U. Fla. L. Rev. 755, 756–57 (1988) (describing the origin of MLPs and the types of transactions that create MLPs).

13. *Id.*; *see also* J.T. Carpenter, Comment, *Master Limited Partnerships Shed a Tier*, 53 S. Tex. L. Rev. 381, 383 (2011) (describing the origins of MLPs and the phenomenon of MLPs' limited partners acquiring the general partner as part of a "GP tuck-in" transaction).

14. Adler, *supra* note 12, at 756–57.

15. A rollout describes a transaction in which the corporate sponsor contributes assets to a limited partnership in exchange for partnership interests that it sells into the market. *Id.* at 757. Similarly, in an acquisition transaction, the corporate sponsor serves as the general partner and sells limited partnership interests to the public. *Id.* With the equity raised, the partnership then purchases assets from either the sponsor or a third party. *Id.*

16. *Id.* at 757–58.

17. Revenue Act of 1987, Pub. L. No. 100-203, 101 Stat. 1330 (codified as amended in scattered sections of 26 U.S.C.).

partnerships for which ninety percent or greater of their income represented "qualifying income."[18] Importantly, qualifying income includes "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 (including fertilizer, geothermal energy, and timber)" and income realized by sale or rents of real property.[19] It is for this reason that the bulk of MLPs traded publicly today are in some way related to natural resources.

B. Structuring the Entity: Organization & Offering

Like a limited partnership, an MLP usually has a general partner, often owned by a corporation or limited liability company (LLC), and numerous limited partners — also known as unit-holders.[20] The following structural description has been referred to as the "sponsored MLP model" by at least one practitioner.[21] In this model, the "sponsor" of the MLP organizes the limited partnership, almost invariably in Delaware,[22] and serves as the general partner, retaining at most a two-percent ownership interest in the MLP.[23] In many cases, the sponsor is a publicly traded corporation operating in the oil and gas space, namely exploration and production ("E&P"). The "sponsor" may hold the general partnership interests itself

18. *See* I.R.C. § 7704(d) (2006 & Supp. II 2008) (defining qualifying income); *see also* I.R.C. § 7704(c)(2) (2006 & Supp. II 2008) (stipulating that a publicly traded partnership "meets the gross income requirements of this paragraph for any taxable year if 90 percent or more of the gross income of such partnership for such taxable year consists of qualifying income" and will be exempted from entity-level taxation); Goodgame, *supra* note 9, at 472 (explaining qualifying income and providing an example of the effect of exemption from entity-level taxation).

19. I.R.C. § 7704(d)(1)(C)–(E) (2006 & Supp. II 2008). "Mineral or natural resource" in the context of I.R.C. § 7704(d)(1)(E) is defined as "any product of a character with respect to which a deduction for depletion is allowable under section 611." I.R.C. § 7704(d)(1)(G) (2006 & Supp. II 2008). These products include those extracted from "mines, oil and gas wells, other natural deposits, and timber." I.R.C. § 611(a) (2006).

20. *See* Philip H. Peacock, *Master Limited Partnerships: At The Crossroads?*, 4 Tex. J. Oil Gas & Energy L. 397, 400 (2008) (detailing the formation and structure of MLPs); Goodgame, *supra* note 9 at 473.

21. *See* John Goodgame, *New Developments in Master Limited Partnership Governance*, 68 Bus. Law. 81, 83 (2012) (defining the traditional governance model of MLPs as the "sponsored MLP model").

22. *See* Peacock, *supra* note 20, at 398 (explaining that "MLPs are typically organized in Delaware because Delaware has a very flexible limited partnership statute that, among other things, provides that the liability of the general partner to the limited partners may be limited by contract.").

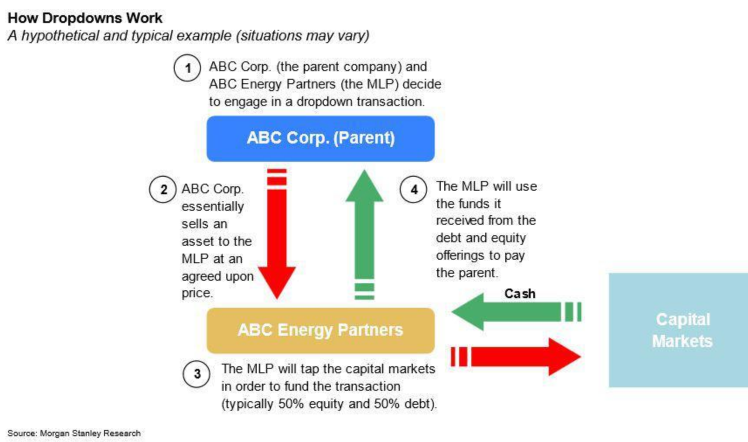
23. *Id.* at 400; Goodgame, *supra* note 9, at 473.

or through a special purpose entity with few assets.[24]

Oftentimes the sponsor contributes the initial assets to the MLP[25], and then sells the common units (i.e., limited partnership interests) into the market through an initial public offering — a "rollout" transaction.[26] Such a transaction may also be referred to as a "dropdown," which better describes the transaction from the sponsor's point of view.[27] Figure 1 illustrates a structural depiction of a dropdown transaction, below. This transactional setup involves a Master Contribution Agreement between the sponsor-parent and the MLP detailing the assets being sold, the consideration, and the method of financing the consideration. In the case of a midstream dropdown (i.e., a pipeline), the sponsor-parent will almost invariably still need the use of the assets for transporting its E&P extractions. Recognizing this, the MLP bonds the sponsor's use of the pipeline under a through-put agreement, typically twenty years in duration or longer, requiring the sponsor to send a minimum amount of extracted product through the pipeline over the life of the agreement. This through-put agreement serves as assurance to the MLP and its unitholders that the recently-acquired midstream asset will continue to generate significant revenue sufficient to justify the price paid and increase investor distributions in the short- and long-term.

24. Goodgame, *supra* note 9, at 473–74.
25. Peacock, *supra* note 20, at 400.
26. *See supra* note 15 and accompanying text (defining a rollout transaction).
27. Peacock, *supra* note 20 at 409.

FIGURE 1: THE MECHANICS OF A DROPDOWN TRANSACTION[28]



As the sponsor, the *modus operandus* for creating an MLP is primarily to monetize assets. A "sale" to an MLP generates cash for reinvestment in the sponsor's other projects that may not constitute "qualifying income" or that may yield a higher return, and the sponsor receives a premium price for its asset because the MLP is not taxed at the entity level.[29] A beneficial dropdown transaction unlocks the greater value of assets generating qualifying income by transferring them to an MLP because the MLP can pay more for the asset since the cash flows it is buying the asset for will only be taxed once, namely not at the entity level. If a new MLP is created, the consideration for the assets is partnership interests, which are converted into cash when some of the units are marketed to the public through an IPO.[30] In the case of a pre-existing MLP, the sponsor may transfer the assets in exchange for cash secured from the capital markets by the MLP through debt and equity offerings.[31]

At this point, it is important to tease out the reasoning behind why sponsors form MLPs in the first place. Aside from the obvious motive of monetizing assets, an MLP can quite clearly function as a funding mechanism for the sponsor. The sponsor is potentially able to avoid an equity offering of its own by monetizing "qualifying income" assets

28. *See* Figure of How Dropdowns Work, SEEKING ALPHA, http://static.cdn-seekingalpha.com/uploads/2014/3/13/20371061-13947623576515193-MLPData.jpg (last visited Oct. 14, 2014) (utilizing diagram created by Morgan Stanley Research to explain the basics of a dropdown).

29. *See* Carpenter, *supra* note 13, at 388 (asserting the reasons why sponsors choose to create MLPs).

30. Peacock, *supra* note 20, at 409–10.

31. *Id.*; *see supra* Fig. 1 (depicting this transaction).

through a dropdown transaction. In doing so, it finances its own NPV-positive projects at a cost of capital it otherwise could not access through the capital markets. As an added benefit, the sponsor continues to receive cash flow from the dropped-down assets thanks to its ownership of the general partner, and in turn the incentive distribution rights, which in some cases can send 20% of the MLP's cash flow to the sponsor.[32] Alternatively, if the sponsor does not have any NPV-positive investments, it can use the cash generated by the dropdown to buy back stock at a lower cost of capital than if it utilized retained earnings, thereby driving up return on equity. In any event, it is clear that sponsors can use MLPs as both a steady source of income (e.g., IDRs) and a financing arm.

The power of the general partner in an MLP is one of the most defining characteristics of "sponsored MLP" governance and differs dramatically from traditional management control in a corporation.[33] Limited partners have no role in the operations and management of the MLP. Though the MLP may have a board of directors, the directors are merely place-fillers since they are generally directors of the general partner appointed by the MLP's sponsor.[34] Because the sponsor often has a vested interest in maintaining control over the assets it contributes to an MLP, it is averse to allowing a third party to control the assets.[35] For example, a sponsor in the oil and gas exploration business may contribute a pipeline to an MLP at the time of organization. However, because the sponsor relies upon the pipeline to transport the product it extracts, it is in its best interest to maintain control over it so as to take advantage of synergies and prevent competition between itself and the MLP.[36]

The sponsored MLP is entirely owned by the parent-sponsor until the IPO of the common units.[37] Furthermore, the MLP typically does not directly own assets, but rather serves as a holding company for subsidiary LLCs, which own the assets.[38] On the IPO date, the parent-sponsor commonly sells less than a quarter of the common units into the market, intentionally retaining the remainder.[39]

Stockholders in corporations and unitholders in MLPs have similar voting rights. For MLP unitholders, these rights are often limited to

32. *See infra* notes 57–72 and accompanying text (detailing the IDR mechanism); *see also infra* note 71 and accompanying text (discussing MLPs in the high splits).

33. Peacock, *supra* note 20, at 400 ("The general partner of an MLP has exclusive control over the operations and activities of the MLP."); *see* Goodgame, *supra* note 9, at 491 (opining on the exclusion of the common unitholders from MLP decision-making).

34. Goodgame, *supra* note 9, at 491.

35. Peacock, *supra* note 20, at 400.

36. *Id.*

37. *Id.*

38. *Id.* at 401.

39. *Id.*

removal of the general partner, merger or consolidation of the MLP, sale of all or substantially all of the assets, dissolution, and actions prohibited by the partnership agreement.[40] Though these rights seem ostensibly similar to shareholder voting rights under Delaware General Corporate Law, they are illusory because MLPs are controlled by their general partners/sponsors, who typically hold a control block, allowing them to forgo annual meetings and to merely appoint the board.[41] Thus, one practitioner has suggested that the only "rational action that a dissatisfied unitholder can take is to vote with her wallet and sell her common units."[42]

C. Distinguishing Features of MLPs

With the foregoing simple explanation of the "sponsored MLP" structure, MLPs become complicated with the introduction of four distinguishing features of MLPs: (1) minimum quarterly distributions and obligation to distribute all "available cash"; (2) subordinated units; (3) incentive distribution rights ("IDRs"); and (4) uniquely favorable tax treatment.

Whereas dividend declarations or retentions are matters of board discretion in corporations, MLPs are constrained by a kind of dividend preference. Common unitholders have an expectation of receiving a quarterly distribution, dubbed the "minimum quarterly distribution."[43] This amount is stipulated in the partnership agreement and must be paid to the common unitholders before any distribution is made to the units retained by the sponsor.[44] Further, if for any reason the minimum quarterly distribution is not distributed in full to the common unitholders in a given quarter, the arrearage must be paid in addition to the minimum quarterly distribution in the successive quarter(s) until the common units are made whole.[45] This provision ties in with the concept of subordinated units (i.e., the sponsor's

40. *See* Goodgame, *supra* note 9, at 491–93 (examining the partnership agreement of Enbridge LP to determine the voting rights of limited partners).

41. *Id.* at 493.

42. *Id.*

43. Peacock, *supra* note 20, at 402.

44. *Id.*; *see* PHILLIPS 66 PARTNERS LP PROSPECTUS (FORM 424B4) A-11 (2013) [hereinafter PHILLIPS 66 PROSPECTUS] (defining "Minimum Quarterly Distribution" as "$0.2125 per Unit per Quarter" in the First Amended and Restated Agreement of Limited Partnerships disclosed in connection with the MLP's offering of 16,425,000 common units).

45. *See* Goodgame, *supra* note 9, at 476 (detailing a similar provision in Enterprise Product Partners, LP's partnership agreement); *see also* PHILLIPS 66 PROSPECTUS, *supra* note 44, at A-46 (stipulating in Section 6.4(a)(ii) that "cumulative common unit arrearage[s]" must be paid to the unitholders "less the General Partner's Percentage Interest" after the unitholders have received that quarter's Minimum Quarterly Distribution).

retained units are junior to the publicly held units for a time).[46] It is believed that minimum quarterly distributions were created in response to underwriters' desire to increase the marketability of MLP common units.[47]

Over the early life of an MLP after its IPO, the partnership agreement provides for favorable treatment of the common units held by the public as compared with those held by the sponsor. As noted earlier, the sponsor typically retains a majority of the limited partner interests (i.e., common units) after an IPO.[48] However, in order to assure equity investors of the minimum quarterly distribution, sponsors have traditionally provided for a "preference" or "subordination" period in the partnership agreement to ensure a minimum yield for these initial investors.[49] During this subordination period, which typically lasts three years,[50] the subordinated units held privately "are not entitled to receive any cash distributions unless and until the common units have been paid the minimum quarterly distribution in full, and any arrearages in the payment of the minimum quarterly distribution to the common units have been eliminated."[51] Furthermore, during this period, it is common to limit the amount of additional equity that the MLP can issue, especially securities senior to the common units.[52] The subordinated units are converted into common units following the subordination period.[53]

These minimum quarterly distributions are to come from the MLP's "available cash."[54] Most MLPs require distribution of all available cash to

46. *See infra* notes 47–52 and accompanying text (discussing subordinated units).

47. Carpenter, *supra* note 13, at 385.

48. *See supra* note 39 and accompanying text (stating that sponsors typically sell less than a quarter of the common units in an IPO).

49. *See* Goodgame, *supra* note 9, at 476 (describing the subordination period as a time when the publicly held common units are given a preferred return to those held by the sponsor).

50. Peacock, *supra* note 20, at 406; *see* PHILLIPS 66 PROSPECTUS, *supra* note 44, at 62 (setting forth a subordination period extending from the closing date of the offering to September 30, 2016, which is a term of approximately three years).

51. Peacock, *supra* note 20, at 406.

52. *See* Goodgame, *supra* note 9, at 477 (listing the "additional" restrictions protecting the yield of the common units during the subordination period).

53. Peacock, *supra* note 20, at 406.

54. *See id.* at 402 (simplifying available cash to mean "cash flow less reserves established at the discretion of the general partner for items such as capital expenditures, operating expenditures (including debt service), and distributions to be made in the future."); *see also* PHILLIPS 66 PROSPECTUS, *supra* note 44, at A-3 (defining "Available Cash" as "the sum of . . . all cash and cash equivalents of the Partnership Group . . . on hand at the end of such Quarter [and] . . . all or any portion of additional cash and cash equivalents . . . resulting from Working Capital Borrowings . . . *less* . . . the amount of any cash reserves established by the General Partner").

the partners on a quarterly basis.[55] Though the general partner has discretion to develop cash reserves for targeted purposes, it is in the general partner's best interest to distribute as much cash as possible to the common unitholders due to its holding of IDRs.[56]

IDRs are easily the most unique facet of MLPs, notwithstanding their tax-favored status, and arguably have the greatest implications for cost of capital. IDRs "are a special class of limited partnership interest that entitle the holder to an increasing percentage of the cash distributions that the MLP pays out to its unitholders as [certain] thresholds are met."[57] They serve the purpose of aligning the interest of the general partner, which typically holds the IDRs, with those of the limited partners (i.e., common unitholders).[58] This structure encourages the MLP to maintain a high distribution and incentivizes the general partner to steadily increase the distribution by appealing to its self-interest.[59] For example, in the case of Phillips 66 Partners LP, which went public in July 2013,[60] the partnership agreement stipulates an initial minimum quarterly distribution ($0.2125/unit per quarter)[61] and then three "target distributions," which, when reached, provide greater shares of the distributions of available cash to the general partner as part of the IDRs.[62] The "First Target Distribution" is $0.244375/unit per quarter,[63] at which point the general partner will receive 15% of the total distribution to the common units exceeding $0.244375/unit.[64] The "Second Target Distribution" is $0.265625/unit per quarter,[65] at which point the general partner will receive 25% of the total distribution to the common units exceeding $0.265625/unit.[66] The "Third

55. Carpenter, *supra* note 13, at 385; Peacock, *supra* note 20, at 402; *see* PHILLIPS 66 PROSPECTUS, *supra* note 44, at A-45–A-46 ("Within 45 days following the end of each Quarter . . . an amount equal to 100% of Available Cash with respect to such Quarter shall be distributed . . . by the Partnership to the Partners as of the Record Date selected by the General Partner.").

56. *See infra* notes 57–72 and accompanying text (discussing IDRs).

57. Peacock, *supra* note 20, at 403.

58. Carpenter, *supra* note 13, at 387.

59. *See* Goodgame, *supra* note 9, at 477–78 (calling IDRs the "most powerful . . . incentive for the general partner contained in MLP partnership agreements").

60. *See Company Overview*, PHILLIPS 66 CO., http://www.phillips66.com/EN/about/Company_Overview/Pages/index.aspx [hereinafter Phillips 66] (referencing the MLP's July 2013 IPO containing primarily midstream assets).

61. *See supra* note 44 (providing the minimum distribution required according to the partnership agreement).

62. *See* PHILLIPS 66 PROSPECTUS, *supra* note 44, at A-46–48 (stating the proper "distributions of available cash from operating surplus.").

63. *Id.* at A-8.

64. *Id.* at 64–65, A-47.

65. *Id.* at A-17.

66. *Id.* at 64–65, A-47.

Target Distribution" is $0.318750/unit per quarter,[67] at which point the general partner will receive 50% of the total distribution to the common units exceeding $0.318750/unit.[68] Table 1, below, from Phillips 66 Partners LP's Prospectus provides a breakdown of cash distributions under this IDR scheme.

TABLE 1: IDR DISTRIBUTION BREAKDOWN[69]

				MARGINAL PERCENTAGE INTEREST IN DISTRIBUTIONS	
				UNITHOLDERS	GENERAL PARTNER
Minimum Quarterly Distribution	$0.2125			98%	2%
First Target Distribution	above $0.2125	up to	$0.244375	98%	2%
Second Target Distribution	above $0.244375	up to	$0.265625	85%	15%
Third Target Distribution	above $0.265625	up to	$0.318750	75%	25%
Thereafter	above $0.318750			50%	50%

When distributions reach the point where 50% of any additional cash distributed accrues to the general partner under the partnership's IDR provision, an MLP is said to be in the "high splits."[70] It is when an MLP reaches the high splits that it becomes more difficult to find projects that are accretive —those projects that will increase the distribution to unitholders — because it must find projects and acquisitions that generate twice as much cash flow as the MLP intends to distribute to its unitholders as a result of the 50/50 split.[71] For example, if the MLP wants to increase distributions by $0.25 to unitholders, its acquisition must be capable of producing additional cash flow of $0.50/unit, since half of the cash flow will be directed to the general partner under the 50/50 IDR split. To address this concern, this Comment will argue in Part II(B) that an IDR

67. *Id.* at A-18.
68. *Id.* at 64–65, A-47.
69. *Id.* at 65.
70. Peacock, *supra* note 20, at 404.
71. *See id.* at 405 (commenting that the high splits of an MLP may actually stunt the growth of the entity because public investors are unwilling to purchase the common units offered in an equity offering unless the project or acquisition contemplated will be accretive to investors in the long run). This has obvious implications on the cost of capital and the permissible capital expenditures that an MLP can make when in the high splits. *See infra* Parts II(A)–(B) (explaining IDRs' effect on cost of capital and methods of remedying the problem created).

reset provision in the partnership agreement is a vital and modest corrective for high splits' effect on cost of capital.[72]

Finally, the tax benefits of MLPs as pass-through entities accrue especially to unitholders by enhancing distributions to its partners and shielding the majority of distributions from taxes in the short-term. Moreover, as referenced in Part I, preferential tax treatment allows the MLP to be more competitive in pursuing acquisitions and projects.[73] The MLP's avoidance of entity-level taxation, 35% in the case of corporations, allows it to distribute significantly more to its partners.[74] This steady return may be particularly attractive to investors who are interested in holding the units for a long period of time and are seeking a high income relative to the price of the unit (i.e., high yield).[75]

High yields emanate from MLPs' ability to shield a large portion of their yields from taxes. As a pass-through, MLPs pass each partner "their allocable share of the partnership's income, gains, losses, and deductions, including accelerated depreciation and amortization deductions in computing their federal income tax liability."[76] These distributions to partners are generally not taxable, but are rather treated as returns of capital, which reduce the common unitholders cost basis in the MLP.[77] The only portion of the cash distribution on which unitholders will be taxed concurrently is the "taxable income allocable" from the MLP — the portion of the distribution attributable to the MLP's net income.[78] It is estimated that the ratio of taxable income to distributions is approximately 20%.[79] In other words, the unitholder would pay tax at their marginal rate on 20% of the total distribution, while deferring payment of taxes on 80% of the distribution until the occurrence of a triggering event (e.g., sale of the units)

72. *See infra* Part II(B) (explaining the mechanics of an IDR reset provision and its effect on cost of capital).

73. *See supra* note 5 and accompanying text (referencing MLPs' competitive advantage over C corporations).

74. *See* Goodgame, *supra* note 9, at 472 (providing an example of the effect of "double taxation" by equating $1.54 of MLP income to $2.20 of corporate income in order to provide $1 of after-tax income to an equity holder with a marginal tax rate of 35%); Peacock, *supra* note 20, at 407.

75. Goodgame, *supra* note 9, at 474.

76. WELLS FARGO MLP PRIMER, *supra* note 2, at 37.

77. *See id.* (contrasting distribution from MLP with distribution from a C corporation that is treated as a dividend and does not affect basis).

78. *Id.*; *see also* Goodgame, *supra* note 9, at 472 (noting the deferral of income taxes for unitholders flowing from the return of capital).

79. WELLS FARGO MLP PRIMER, *supra* note 2, at 37; *see also* Peacock, *supra* note 20, at 408 (stating that many MLPs estimate the amount of allocable income to partners as 20% or less when they go public).

to the extent the unitholder's adjusted basis exceeds the non-taxable distribution amount.[80]

D. *Fiduciary Duties*

Whereas broad fiduciary duties are considered the bedrock of Delaware corporate law, they are often explicitly excluded from alternative entities like MLPs.[81] Since August 1, 2004, the Delaware Revised Uniform Limited Partnership Act ("DRULPA") has permitted the expansion, restriction or elimination of fiduciary duties.[82] The relevant section of the DRULPA, section 17-1101(d), states:

> To the extent that, at law or in equity, a partner or other person has duties (including fiduciary duties) to a limited partnership or to another partner or to another person that is a party to or is otherwise bound by a partnership agreement, the partner's or other person's duties may be expanded or restricted or eliminated by provisions in the partnership agreement; provided that the partnership agreement may not eliminate the implied contractual covenant of good faith and fair dealing.[83]

Amongst MLPs, the elimination of fiduciary duties has become a common practice.[84] In a September 2012 study of eighty-six "publicly traded non-corporate business associations" (LLCs and LPs), it was found that over

80. WELLS FARGO MLP PRIMER, *supra* note 2, at 37.

81. *See generally* Goodgame, *supra* note 9, at 485-87 (describing the divergence between the Delaware General Corporate Law and the Delaware Revised Uniform Limited Partnership Act).

82. *See id.* at 487 n.87 (reasoning that the Delaware legislature possibly amended the provision to add terminology permitting elimination of fiduciary duties in response to dictum in *Gotham Partners v. Hallwood Realty Partners*, 817 A.2d 160, 167–68 (Del. 2002), which concluded that a limited partnership agreement could not eliminate fiduciary duties because the statute lacked the word "eliminate").

83. Delaware Revised Uniform Limited Partnership Act, DEL. CODE ANN. tit. 6, § 17-1101(d) (2010).

84. *See generally* Brent J. Horton, *The Going-Private Freeze-Out: A Unique Danger for Investors in Delaware Non-Corporate Business Associations*, 38 DEL. J. CORP. L. 53 (2013) (examining the provisions of LLC operating agreements and LP agreements for publicly traded entities that stipulate special approval provisions for dealing with conflicts or eliminate fiduciary duties); Mohsen Manesh, *Contractual Freedom Under Delaware Alternative Entity Law: Evidence from Publicly Traded LPs and LLCs*, 37 J. CORP. L. 555 (2012) (discussing the widespread use of fiduciary duty waiver and exculpation provisions among alternative entities and the justifications for such contractual provisions).

fifty-two percent eliminate fiduciary duties entirely.[85] Similarly, a June 2011 study of eighty-five publicly traded firms determined that only ten (11.76%) of the firms do not substantially alter default fiduciary duties — forty-two (49.41%) "fully waive the fiduciary duties of the firm's managers," while another thirty-three (38.82%) firms eliminate liability stemming from breach of fiduciary duties (88.24% cumulatively).[86]

Eliminating fiduciary duties in MLPs makes sense for the unitholders to the extent that both management and unitholders interests can be aligned economically through contract — a "contractarian" viewpoint, which will be revisited in Part II(C).[87] It is alleged that the incentives and framework established contractually in the partnership agreement can adequately supplant fiduciary duties and, in doing so, constrain agency costs that arise from enforcement by "derivative plaintiffs and their lawyers who, like corporate managers, may have interests different from those of the owners."[88] The two contractual provisions of MLPs that serve to support this assertion are the minimum quarterly distributions and the IDRs. In the case of minimum quarterly distributions, managerial discretion is curbed with regards to retaining cash flow due to mandatory distribution of "available cash."[89] Similarly, the IDRs incentivize the general partner to maximize distributions, which inure to the benefit of the limited partners and the general partner, and "likely promote proper management of the MLP and its assets."[90] The contrary viewpoint on IDRs is that such an incentive-based contract may encourage the general partner to increase distributions aggressively, ignoring earnings retention, to the detriment of long-term value.[91] Alternatively, it can be argued that the general partner gets a disproportionate percentage of firm profits not commensurate with its ownership stake, which encourages excessive risk.[92]

This Comment will maintain in Part II that the contractual provisions allowing MLPs to engage in ostensibly interested transactions with its sponsor through further dropdowns of assets generating "qualifying income," though questionable under traditional conceptions of the duty of

85. *See* Horton, *supra* note 84, at 94 (finding that 29.41% of LLCs and 57.97% of LPs that are publicly traded feature these elimination provisions).

86. Manesh, *supra* note 84, at 574.

87. *See infra* Part II(C) (explaining in greater depth the theory of uncorporation and its applicability to MLPs). *See generally supra* note 8 (referencing the works of noted contractarian Larry Ribstein).

88. Ribstein, *Partnership Governance*, *supra* note 8, at 297.

89. *Id.* at 290–91. *But see* Manesh, *supra* note 84, at 590 (asserting that "the disciplinary effects of compelled distributions are dubious given the fact that the managers are contractually entitled to determine what constitutes 'available cash.'").

90. Goodgame, *supra* note 9, at 479.

91. Manesh, *supra* note 84, at 591.

92. *Id.*

loyalty, is an important tool in maintaining a competitive cost of capital for the firm. As such, Part II will argue that the "sponsored MLP model" remains the entity of choice for cost of capital purposes despite the recent experiments with LLCs and GP tuck-ins.

II. Cost of Capital in Conventional MLPs

Because the attractiveness of MLPs to investors depends heavily upon their maintaining and growing distributions to investors, it is paramount that the MLPs have access to capital markets or, at the least, a sponsor with a plethora of "qualifying income" assets that can be "dropped down" to the MLP.[93] Intuitively, in order for investors to contribute this capital, the contemplated transaction must cost less than the expected return — in other words, the rate of return must exceed the MLP's cost of capital to be an accretive investment.[94] The likelihood of an "acceptable return" is heavily determinative of the cost of capital (i.e., the price equity investors are willing to pay and the interest rate at which capital is lent).[95] Another significant facet of MLPs that necessitates keeping the cost of capital low is the fact that many of them own "steady cash flow" assets — midstream assets like pipelines — making it unlikely that the rate of return on the acquisition, albeit reliable, would permit an inflated cost of capital.[96]

Whereas MLPs undoubtedly benefit from their pass-through status for cost of capital purposes, it is clear that when the IDRs reach the high splits (i.e., 50% of increased cash flow accruing to the sponsor/general partner), this cost of capital advantage over C corporations can disappear.[97] As such, in the past five years, existing and newly-formed MLPs have tried many alternatives to mitigate this apparent roadblock to growth inherent in the "sponsored MLP model" of governance.[98] However, it remains to be seen whether the use of alternative entity types has remedied this issue. If the past two years are any indication, the "sponsored MLP model," complete with high-splits IDRs, remains the governance model of choice, proving that "the value inherent in owning IDRs appears to outweigh the

93. *See* Goodgame, *supra* note 9, at 501–02 (concluding that "the MLP structure encourages the general partner to cause the MLP to finance its growth at least in part through the raising of capital."). *See generally supra* notes 29-31 and accompanying text (defining "drop-down" transactions).

94. Goodgame, *supra* note 9, at 502; *see* Wells Fargo MLP Primer, *supra* note 2, at 28 (commenting that MLPs have typically enjoyed favorable access to capital markets).

95. Goodgame, *supra* note 9, at 502.

96. *Id.*

97. *See* Wells Fargo MLP Primer, *supra* note 2, at 104–06 (discussing Wells Fargo's method of estimating an MLP's cost of capital).

98. *See id.* at 98 (discussing rationales for differing MLP governance structures).

challenges of a higher cost of equity for GP owners."[99] This Comment reaches the same conclusion in this Part and argues that a contractual provision allowing the general partner to reset the IDRs is a most appropriate method of reducing an MLP's cost of capital.

A. Effect of Incentive Distribution Rights on Cost of Capital

According to Wells Fargo's analysis as of the 2nd Quarter of 2013, there were twelve MLPs paying 20% or more of their total cash to their general partner,[100] arguably due to their IDRs reaching the 50/50 high-splits threshold. This increased burden has been termed the "GP tax" and is a serious impediment to the long-term growth prospects of the MLP.[101] As one author has put it, with an increasing cost of capital and investors' enduring desire for greater distributions, "there inevitably comes a moment when the two competing realities . . . intersect."[102] This intersection is the high splits of IDRs.

In determining the cost of equity for an MLP, Wells Fargo has advocated for a calculation that sums: (1) the forward yield adjusted for the general partner's share of cash flow over the common units' percentage of cash flow, and (2) distribution growth.[103] By Wells Fargo's calculations, an MLP without IDRs can make investments at eleven to twelve times earnings before interest, taxes, depreciation, and amortization ("EBITDA") and still have an asset accretive to the MLP (i.e., an investment which increases distributions to unitholders).[104] By contrast, an MLP with a maximum IDR tier of 50% with the same assumptions would only be able to pay seven to eight times EBITDA in order to ensure that the investment remains accretive over its lifetime.[105] Assuming an initial cost of equity capital (rate of return) of 10% (7% forward yield + 3% distribution growth), charting the growth of the cost of equity as a function of the increased cash flow to the general partner, an MLP's required rate of return will approximately double as it reaches the high splits (50% IDR).[106] As a

99. *See id.* (noting that as of October 31, 2013, nineteen of the twenty-four MLPs that had completed IPOs since 2012 included a maximum IDR in their structure, with all midstream MLP IPOs including a 50% IDR tier).

100. *Id.* at 97.

101. *Id.*

102. Carpenter, *supra* note 13, at 413.

103. *See* WELLS FARGO MLB PRIMER, *supra* note 2, at 104 (calculating the forward adjusted cash yield as the next four quarterly distributions, divided by the current unit price, and adjusted for the general partner's share of cash flow).

104. *See id.* at 105 & Ex. 105 (assuming a yield of 7%, a cost of debt of 7%, and distribution growth of 3%).

105. *Id.*

106. *Id.* at 105–106 & Ex.106.

result, if the MLP wishes to fund an acquisition with new equity, the acquired investment must generate cash flow "at least double the aggregate current distribution rate on those newly-issued common units" in order to be accretive to the new equity investors.[107]

B. *Combating Rising Cost of Capital*

Tactics to combat the rising cost of capital stemming from IDRs seemingly fall into two categories. The first calls for the elimination of IDRs through one of the following methods: (1) the use of another entity type (e.g., an LLC) to go public; (2) a "GP tuck-in" transaction; (3) a variable distributions provision; or (4) the unilateral elimination of IDRs by the general partner. The other side of the coin contemplates the maintenance of IDRs and includes: (1) general partner subsidies through temporary suspension of IDRs; (2) maximum IDR splits of 25% rather than 50%; or (3) an IDR reset option.

Action precipitating from cost of capital concerns with the "sponsored MLP model" first arose in the early 2000s, possibly in response to Enron.[108] Needless to say, the collapse of Enron led to significant discussion and scholarship over incentive structures and pitfalls of modern corporate governance.[109] In the context of MLPs, a push was made for "good governance" as determined by market pressures.[110] The first step taken by a few MLPs towards this supposed "market optimal governance" involved the unveiling of the "public LLC model."[111] Under this structure, the LLC would not have a managing member, but would be managed by a board of directors elected by the unitholders, which would owe fiduciary duties like those owed by directors and officers in Delaware corporations.[112] As with corporations, these LLCs often contain exculpatory provisions from duty of care violations, but the duty of loyalty remains intact.[113] Furthermore, the operating agreement of the LLC would

107. Goodgame, *supra* note 9, at 504.

108. *See id.* at 503 (noting that GulfTerra's "Independence Initiatives," which was intended to distinguish itself from sponsor El Paso Corporation, occurred shortly after "the Enron debacle").

109. *See* William W. Bratton, *Enron and the Dark Side of Shareholder Value*, 76 Tul. L. Rev. 1275 (2002) (pointing out that the incentive structure of corporate governance pervasive during the lead-up to the Enron bankruptcy failed to serve as a meaningful check on management and needed overhaul).

110. *See* Goodgame, *supra* note 9, at 502 (asserting that investors will shy away from MLPs viewed as favoring their sponsors over the interests of their common unitholders).

111. *See* Goodgame, *supra* note 21, at 87–88 (describing the November 2004 IPO of Copano Energy, LLC).

112. *Id.* at 88.

113. *Id.* at 90.

not provide for any minimum distributions or incentive-based compensation for management.[114] It may have been believed that by making MLPs mirror the governance standards expected of corporations, lenders and investors would view them more favorably for purposes of extending capital. There are currently five traded LLCs among publicly traded energy partnerships.[115]

The next method of reducing the cost of capital through IDR elimination emerged in 2007 when MarkWest Energy Partners, LP purchased its general partner MarkWest Hydrocarbon, Inc. in a merger, thereby collapsing the IDRs into the MLP.[116] The resulting entity instituted unitholder elections of the general partner's board of directors and cancelled the IDRs.[117] Notably, the entities that have undergone these "GP tuck-in" transactions have not adopted traditional corporate fiduciary duties for their boards.[118]

Third, and recently attempted by four MLPs that went public in 2011-2012, an MLP may go public with variable distributions of all "available cash" instead of a required minimum quarterly distribution.[119] Though the entity still has a general partner who retains control, the general partner has a non-economic interest and thus its sole incentive to pay out and increase cash distributions "lies in the general partner's and sponsor's ownership of common units that benefit and suffer alongside those owned by the public."[120] Finally, and most unlikely, an MLP's general partner may eliminate its IDRs completely of its own accord.[121]

Conversely, many MLPs have maintained IDRs, but have utilized creative methods in attempts to avert the strain that high splits can place on the entity's cost of capital. The first method is general partner subsidization of acquisitions. This technique involves the general partner's unilateral decision to forgo its contractual IDR payments for a defined or indefinite term so that an acquisition is adequately accretive to common unitholders.[122] Secondly, an MLP may amend its partnership agreement to reduce its highest level IDR to 25% (i.e. 2% general partner units share &

---

114. *See id.* at 88 (noting that "the Copano board is incentivized — like the board of any other public corporation — by its prospects for re-election.").

115. WELLS FARGO MLP PRIMER, *supra* note 2.

116. Goodgame, *supra* note 21, at 91–93. *See generally* Carpenter, *supra* note 13 (discussing the GP tuck-in phenomenon).

117. Goodgame, *supra* note 21, at 92.

118. *Id.* at 93.

119. *See id.* at 95–97 (describing variable distribution MLPs).

120. *Id.* at 97.

121. *See* WELLS FARGO MLP PRIMER, *supra* note 2, at 96 (mentioning Enterprise Product Partners which eliminated its IDR structure completely in 2010).

122. See *id.* at 100–01 (listing twenty-four general-partner-subsidized transactions dating from November 2004–October 2013).

23% IDR distribution). Enterprise Products Partners, LP was seemingly the first MLP to make this move when the MLP's general partner elected to cap its distributive share at 25%, reducing it from the status-quo 50% threshold under conventional IDRs.[123] There has been speculation that a growth in institutional investors in the MLP market may pressure a move towards capping IDRs below their usual 50% share.[124]

The final method employed by MLPs to reduce cost of capital while maintaining IDRs is the IDR reset option. It is believed that DCP Midstream Partners, LP was the first MLP to adopt such a cost of capital protection mechanism.[125] According to Phillips 66 Partners' Prospectus, the rationale for utilizing this reset option is "in order to facilitate acquisitions or internal growth projects that would otherwise not be sufficiently accretive to cash distributions per common unit, taking into account the existing levels of incentive distribution payments being made to our general partner."[126] Embedded in the MLP's partnership agreement, the IDR reset option is typically exercisable by the general partner after four consecutive quarters of distributions at the 48% IDR level (50% if including the general partner's 2% interest).[127]

Under the provisions of the reset, the new minimum quarterly distribution will be the average of the two quarterly cash distributions preceding the IDR reset election.[128] Furthermore, the new target distributions will represent 115%, 125%, and 150% of the reset minimum quarterly distribution.[129] As an example, assume the new minimum quarterly distribution is $1.00. Therefore, the first target distribution would be $1.15 (115% of $1.00), the second target distribution would be $1.25 (125% of $1.00), and the third target distribution would be $1.50 (150% of $1.00). Just like the first IDR iteration, the general partner would roughly receive 2% of distributions less than or equal to $1.15, 15% of the cash

123. *See* Goodgame, *supra* note 9, at 504 (including an explanation of the decision to cap its distribution made by Enterprise's CEO in which he referenced a reduced "cash cost of capital, which should enable us to provide our limited partners with greater economic returns on capital investments").

124. *Id.* at 505; *see* also Goodgame, *supra* note 21, at 98 (stating that institutional investors owned approximately 31% of all outstanding MLP equity as of March 21, 2012).

125. *See* DCP Midstream Partners, LP, Prospectus (Form 424B4), at 61–63 (Dec. 2, 2005) [hereinafter DCP Midstream Prospectus] (describing DCP Midstream Partners' IPO and the general partner's right to reset the IDRs and the general partner's compensation resulting from the reset).

126. Phillips 66 Prospectus, *supra* note 44, at 65.

127. *See id.* (stipulating that this right inures to the general partner as the holder of the IDRs and is not subject to approval by "our unitholders or the conflicts committee").

128. *See id.* at 66 ("[f]ollowing a reset election, the minimum quarterly distribution amount will be reset to an amount equal to the average cash distribution amount per common unit for the two fiscal quarters immediately preceding the reset election").

129. *Id.*

distributions between \$1.15 and \$1.25, 25% of the distributions between \$1.25 and \$1.50, and 50% of all distributions over \$1.50.

However, unlike Enterprise Product Partners' voluntary elimination of IDRs, an IDR reset election does not occur without contractual compensation to the general partner. A standard IDR reset clause provides for the issuance of Class B common units to the general partner as compensation as well as the issue of enough general partner shares to maintain the general partner's interest at 2%.[130] These newly-issued common units will throw off cash equal to the average of the IDR payments to the general partner in the two previous quarters.[131] Therefore, the number of Class B common units the general partner receives will be the average quarterly IDR payments divided by the average quarterly cash distribution to the common units — both numbers being an average of the two preceding quarters.[132] For example, if the general partner received an average of \$5 million per quarter stemming from its IDR ownership and the average cash distribution per common unit was \$.50, the number of Class B common units the general partner would receive for the reset would be ten million (\$5 million divided by \$.50). Often times, these Class B units are convertible to common units after a defined period of time, typically one year.[133] Though this compensation is clearly dilutive of the common unitholders, a general partner is likely to exercise this reset only if doing so facilitates growth for the MLP through a substantially accretive investment that will increase the cash distribution to the common unitholders in both the short- and long-term. It is important to realize that the reset does not change the immediate cash flow to the general partner, but rather reduces the future cash flows, which affect future distributions.[134]

The maintenance of IDRs with situational modifications to accommodate accretive acquisitions is a persuasive mechanism for MLPs in that the interests of general partners (i.e., parent-sponsors) and limited partners are economically aligned. This conceptual framework aligns itself

---

130. *Id.*
131. *Id.*
132. *Id.*
133. *See* DCP Midstream Prospectus, *supra* note 125, at 62 (providing that "[e]ach Class B unit will be convertible into one common unit at the election of the holder of the Class B unit at any time following the first anniversary of the issuance of these Class B units.").
134. *See* WELLS FARGO MLP PRIMER, *supra* note 2, at 101 (stating that "the GP would receive a lower percentage of incremental cash flow at the reset (higher) MQD than the 50% of incremental cash flow that it would receive under the initial distribution schedule. Hence, by resetting the incentive distribution tiers, the MLP's cost of equity is effectively reduced."). For a detailed accounting depiction of an IDR reset, *see EVEP and the IDR Reset*, MLP PROTOCOL, http://mlpprotocol.files.wordpress.com/2011/11/evep-and-the-idr-reset.pdf.

with "contractarian" legal scholarship, which aimed to undermine the widely-held belief that the corporate form was the ideal entity type for large firms. In the context of MLPs, which have successfully operated under contractual constraints rather than corporate law frameworks for over twenty-five years, a theory favoring "uncorporation" seems not only plausible, but preferable.[135]

C. *Theory of Uncorporation Manifested in Conventional MLP*

The late legal scholar Larry Ribstein defined "uncorporate" business as including partnerships and LLCs.[136] Ribstein witnessed firsthand the advent of publicly traded "uncorporate" entities — namely partnerships like MLPs and private equity firms. In advocating for these entities' viability and optimality for certain large firms, he identified three key aspects of "uncorporate" entities that made them adequate substitutes for, if not better than, C corporations with respect to "fiduciary duties and other traditionally corporate mechanisms for ensuring managerial accountability."[137] These three aspects are: (1) mandatory distributions; (2) managers as partners; and (3) limited duration followed by mandatory liquidation.[138] Simply put, these features should operate to reduce agency costs associated with "ineffective corporate-type monitoring devices."[139] MLPs commonly exhibit two of these traits: mandatory distributions and managers as partners. Considering that many of the largest MLPs are composed of primarily midstream assets (e.g., pipelines) and have IDRs, an argument exists that these "uncorporate" facets are a contributing factor to MLPs' tremendous performance compared with the market. By way of example, a comparison of return on investment between Alerian's MLP Index (AMZ) and the S&P 500 was conclusively in MLP's favor.[140] AMZ experienced an annualized return of 15% compared with S&P's 7.4% over the last ten years and an investment of $1000 would have grown to $4058 with AMZ compared with $2043 with S&P.[141]

---

135. *See supra* note 8 and accompanying text (listing four articles written by Ribstein).

136. Ribstein, *Uncorporation*, *supra* note 8, at 125.

137. *See* Ribstein, *Partnership Governance*, *supra* note 8, at 290–92 (comparing corporations and partnerships with respect to distributions, liquidation, and manager ownership in the firm); *see also* Manesh, *supra* note 84, at 564 (identifying three uncorporate governance devices from Ribstein's book "Rise of the Uncorporation").

138. Manesh, *supra* note 84, at 564.

139. Ribstein, *Partnership Governance*, *supra* note 8, at 290.

140. *See Alerian MLP Index Fact Sheet*, ALERIAN, http://www.alerian.com/wp-content/uploads/AMZfacts.pdf (last visited Mar. 21, 2014) (comparing Alerian's index of fifty prominent MLPs with the return on other investment vehicles available in the market).

141. *Id.*

The first "uncorporate" aspect prominent amongst MLPs is the existence of mandatory distributions, or, in more appropriate terminology, required distribution of all "available cash."[142] Conceptually, limiting the discretion managers have to retain earnings reduces the need to monitor managers' use of "free cash flow."[143] In MLPs, "free cash flow" is more or less defined as "available cash," which must be distributed to unitholders. The discretion that MLP managers have to retain cash for capital expenditure purposes is patently different from the same determination made by a corporate board. MLP managers, often appointed by the general partner who is controlled by the MLP's sponsor, are incentivized to distribute as much as possible due to the IDRs that serve to enhance the general partner/sponsor's share of cash flow. As a result, managers of MLPs invariably do not have sufficient cash on hand to fund accretive acquisitions, which forces them to seek investment from the capital markets.[144] Therefore, the theory follows that an efficient capital market will serve as a monitor for MLP management and will impute higher costs of capital for management inefficiencies.

The effect of "compelled distributions" has been attacked as "dubious" since MLP managers have the discretion to determine what constitutes "available cash."[145] It is alleged that the implication of discretion is inescapably contradictory to mandatory distributions.[146] Yet in the same vein, it is conceded that IDRs create an incentive to maximize these "compelled distributions," but also create perverse incentives to "aggressively increase distributions" and in doing so "driv[e] the firm to riskier investments and acquisitions" at the expense of "prudently retaining earnings and managing distributions to maximize long-term value."[147] In the first instance, managerial discretion is the evil, and in the second, the absence of managerial discretion is the shortcoming to mandatory distributions. How can it be both? Rather, what is missing is the understanding that though many MLPs are vehicles for growth and have an

---

142. *See supra* notes 43-50 and accompanying text (describing minimum quarterly distributions and MLPs' contractual mandate to distribute all available cash); *see also supra* note 8 and accompanying text (unveiling Ribstein's thesis of uncorporation).

143. Ribstein, *Partnership Governance*, *supra* note 8, at 290; *cf.* Michael C. Jensen, *Agency Costs of Free Cash Flow, Corporate Finance, and Takeovers*, 76 AM. ECON. REV. (Papers & Proc.) 323 (1986) (defining free cash flow and suggesting the use of debt to eliminate agency issues arising from managers' misuse of free cash flow).

144. Manesh, *supra* note 84, at 565; *see* Ribstein, *Uncorporation*, *supra* note 8, at 128 ("Unlike corporate managers, uncorporation managers cannot rely on a permanent cache of equity capital to fund their ventures. Their need to keep seeking funding ensures that their activities will be continually monitored by the capital markets.").

145. Manesh, *supra* note 84, at 590.

146. *Id.*

147. *Id.* at 591.

incessant need for capital, they are nevertheless "low-growth firms"[148] in that they are often invested in fixed-fee, "steady cash flow" assets like pipelines rather than more speculative, exploration and production assets.[149] This characteristic of most MLPs makes their depiction as risky investments more dubious because the entity is not likely to make the investments absent near assurance that its cash flow will generate sufficient cash to justify the cost of capital.[150] Finally, to the extent that the general partner (owned by the sponsor) derives economic benefit from mandatory distributions, the limited partners will benefit in kind with greater investment return — the economic interests of the parties are inescapably intertwined, incentivizing efficient management.

MLP management is further connected to the financial performance of the entity through its ownership of partnership units — the second facet of uncorporate entities. Many MLPs are constructed such that the general partner has a 2% equity interest, which is small in comparison to their control over the entity. However, it is important to recall that when an MLP goes public, the vast majority of the common units authorized are kept by the sponsor and are defined as subordinated units, playing second fiddle to the common unitholders' minimum quarterly distributions.[151] Therefore, in addition to the IDRs, an MLP's parent/sponsor shares in the plight of the limited partners, exposing them to "the same upside potential and downside risks as their investors."[152]

Interestingly, several MLPs employ the sponsored MLP model, but lack IDRs or general partner equity interests. However, the common bond they share is that their parent/sponsor maintains ownership of a large block of limited partner interests such that it is aligned with the common unitholders' interests. Enterprise Products Partners is the chief of these as the largest MLP by market capitalization. Its parent/sponsor, Enterprise Products Company and its affiliates, own 36.4% of the limited partner interests in the MLP as of December 31, 2013.[153] Simply put, the general partner is unlikely to engage in conduct that would sufficiently harm the

148. *See* Ribstein, *Uncorporation*, *supra* note 8, at 128 ("This uncorporate device is better suited to mature, low-growth firms, which can set specific financial targets and time-frames.")

149. *See* Goodgame, *supra* note 9, at 502 ("[A]ssets typically owned or acquired by MLPs are 'steady cash flow'-type assets and not more speculative, high-growth-type assets")(footnote omitted).

150. *Id.*

151. Peacock, *supra* note 20 at 401 ("It is not unusual for the parent/sponsor to initially sell only a small portion (15-20%) of the total limited partner interests in the initial public offering and retain the rest."); *see supra* note 38 and accompanying text (explaining that MLPs normally act as holding companies for "subsidiar[y]" LLCs, which own the assets.).

152. Manesh, *supra* note 84, at 565.

153. Enter. Prods. Partners, Annual Report (Form 10-K), at 1 (Mar. 3, 2014).

economic status of the limited partners considering its stake as the sponsor. Considering the sponsor's significant investment in the MLP, a "sell-down" — an abrupt sale of a large holding of units into the market — by the sponsor could result in a significant drop in the value of the common units as the sponsor and MLP's interests become less aligned.[154]

The effect of mandatory distributions and manager ownership of the partner interests seem to serve as an excellent check on MLP management, ensuring the best investment outcome for common unitholders. When general partners/sponsors and common unitholders have the same skin in the game, both parties can end up as winners. The uncorporate entity embodied in MLPs supports this mutualistic relationship, as MLPs fare well in the market for investors and sponsors are able to monetize assets and generate steady cash flow for their role in aiding MLPs' accretive growth.

Conclusion

Most recently, Kinder Morgan has added to the confusion over whether sponsored MLPs are viable long-term through its $70 billion reorganization, which folded its two MLPs into the "parent" C corporation.[155] The reasons proffered for the extensive restructuring were the MLPs' prohibitively high costs of capital and the need to lower the cost of capital to pursue more investments.[156] It is possible that the Kinder Morgan consolidation will touch off a chain reaction of corporations acquiring the MLPs that they have developed through dropdowns. The market response to Kinder's consolidation has been largely positive thus far, though at the expense of the old MLPs' unitholders, which were hit with a large tax bill as result of the deal.[157] Though Kinder has removed itself from the MLP arena with this deal, it remains to be seen whether it will form MLPs in the future as it is now holding a plethora of qualifying-income assets. It would not be surprising to see Kinder drop new MLPs in the future to combat rising costs of capital at the corporate level, which is arguably the rationale for forming MLPs in the first place.[158]

---

154. Goodgame, *supra* note 21, at 94.

155. Brian Nelson, *Kinder Morgan Consolidation: Not for the Reasons You Think*, Seeking Alpha, http://seekingalpha.com/article/2517775-kinder-morgan-consolidation-not-for-the-reasons-you-think.

156. *Id.*

157. Laura Saunders, *The Bill Comes Due on Kinder Morgan MLPs*, Wall St. J., Aug. 29, 2014, http://online.wsj.com/articles/the-tax-bill-comes-due-on-kinder-morgan-mlps-1409335312.

158. *See* discussion *supra* Part I.B (asserting that C corporations may utilize MLP dropdowns as a method of capitalizing the corporation at a discount compared with the cost of capital otherwise available to the corporation through the capital markets).

MLP governance is clearly going through a significant period of experimentation and flux as sponsors seek the best method to monetize their qualifying income-producing assets while still making the entity sufficiently accretive to prospective limited partners. The maintenance of economic incentives improves the lot of both sponsors and common unitholders in that sponsors are encouraged to drop down assets that will be accretive long-term to the common unitholders in exchange for capital to reinvest elsewhere and a share of the assets' future cash flows (i.e., IDRs).

Though high-split IDRs are an unquestionable detriment to cost of capital, it is also clear that IDRs, if managed and restricted, can continue to be a boon to MLPs. The IDR reset mechanism provides a method that compensates a general partner with further equity immediately in exchange for a smaller share of future cash flows, thereby reducing the cost of equity capital. It has arguably become a best practice to include an IDR reset provision in MLPs' partnership agreements if the MLP utilizes IDRs to incentivize the general partner. Flexibility for the general partner to decrease the cost of capital is not an evil for equity holders since the two parties are economically bound at the hip. Furthermore, so long as MLP common unitholders continue to see market-besting returns, it is doubtful that they will look the gift horse that is sponsored MLP model governance in the mouth.