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Joint Venture Traps To Avoid

Midstream firms should recognize issues that can cause problems for an MLP structure when drafting a joint venture agreement.

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Joint ventures (JVs) are commercial collaborations in which two or more unrelated parties pool, exchange or integrate some of their resources with a view to mutual gain, while at the same time remaining independent.

MLPs and would-be MLPs use JVs for many different reasons. These JVs can be with private-equity sponsors, customers, private or public companies or other MLPs. For midstream MLPs, JVs are used for multiple purposes, including funding asset development costs, locking in customers or building scale.

Midstream MLPs have partnered with various private-equity providers to expand existing midstream assets or to construct new assets. These agreements typically provide for the private-equity partner to receive a share of the JV profits in exchange for funding the required capital. JVs have also been used as a vehicle for two non-MLP parties to combine their midstream assets to create a more substantial midstream entity structured as an MLP that will better compete for projects.

Midstream MLPs have also partnered with upstream producer customers in JVs to develop assets. As

part owners of the asset, the customers are more likely to continue using the asset and commit to long-term takeaway capacity payments.

While the economic terms and control rights of JVs are critically important to the parties, there are many other issues to consider when forming a JV, some of which are impacted by whether the JV will ultimately become part of an MLP structure. Several of these issues are raised below for consideration by potential JV parties and their counsel in connection with the formation of a JV that is intended to be included in an MLP structure.

Form of entity—A JV can be formed as a legal entity owned by the partners or as a purely contractual arrangement between the JV partners. Here, we assume the JV will be formed as a separate entity. Tax treatment is likely to be the most important factor in the determination of which type of entity to use.

In order to be incorporated into an MLP structure, the primary JV entities should be pass-through entities, typically liability companies. While entities taxed as corporations can exist in an MLP structure, their existence reduces the tax efficiency of the MLP structure.

Scope and purpose—The JV formation documents will identify the scope and purpose of the venture. This scope/purpose can define the nature of the JV's business, potential future lines of business into which the JV may expand, geographic areas in which the JV will or may operate and how deviations from the scope will be determined and approved by the partners.

Accordingly, the scope/purpose clause has implications on non-compete obligations and corporate opportunity issues to which the partners and their affiliates may be subject. These implications become more important in JVs between midstream MLPs when the JV is formed to operate in a new area of operations for both JV partners or current areas of operations for one or both of the partners. The partners should clearly define what activities the JV should do or refrain from doing, and the existing and potential future conflicts with each partner's non-JV businesses in order to appropriately address these implications.

Structuring debt—JVs and their partners often incur debt or project financing in connection with the JV's activities. If—in connection with the contribution of a JV to an MLP—the MLP assumes the liability of a contributing partner for such debt, the MLP is treated as transferring cash consideration to the partner to the extent that the amount of the liability exceeds the partner's share of that liability immediately after the contribution. Ensuring the JV debt is a "qualified liability" allows the contributing partner to defer the gain for such consideration and reduce its tax basis for the deemed shift in its share of liabilities.

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While there are several alternatives that allow debt to be treated as a qualified liability, any debt allocable to capex related to the JV's properties is considered a qualified liability. Tax counsel should be consulted in advance of structuring debt or project financing in connection with the JV formation.

Structuring contracts—A fundamental requirement of an MLP is that at least 90% of its gross income each taxable year is "qualifying income" under the Internal Revenue Code and its regulations. Whether an MLP generates qualifying income depends on multiple factors, including the contractual terms pursuant to which the MLP performs its activities for its customers.

For example, if a JV's customer has significant elements of control over the operation of a JV facility that would otherwise produce qualifying income, there can be risk that such income is non-qualifying leasing income, and not qualifying oil and gas transportation or processing income. Tax counsel should be consulted regarding structuring any JV contractual arrangements with customers.

MLP investors demand the highest level of certainty on qualifying income issues.

Transfer restrictions—Parties typically want to be able to choose their partners. For this reason, JVs typically include transfer restrictions that prevent a party from transferring its interests without the other party's consent.

At the JV's formation, if a contribution to an MLP is contemplated by one of the parties—or even remotely possible—the agreement should provide for the ability to complete any such transfer. In circumstances where one partner is not amenable to an open-ended transfer provision, the agreement should permit transfers to affiliates and define "affiliate" to include an MLP controlled by the partner.

It is also important to avoid broadly drafted transfer restrictions that could prevent an MLP joint-venture party from effecting an MLP change-of-control transaction that is unrelated to the JV.

Disclosure of information—MLPs, because they are public companies, must satisfy disclosure obligations under securities laws. Pursuant to those obligations, it is possible that an MLP will be required to disclose information about the

JV (including the terms of the JV agreement, the assets, the JV partners, etc.) and file standalone financial statements for the JV. Confidentiality provisions in the JV agreements and in any contracts to which the JV is a party should be drafted to permit any such required disclosures.

If legal or accounting counsel determines that JV financial statements will be required by the MLP, the JV should be required in the agreement to timely deliver financial statements satisfying the applicable disclosure requirements. In addition, the JV should be required to cause its auditor to provide any assistance necessary in connection with these disclosure requirements and the MLP's financing activities.

Exit plans—Thoughtful exit provisions customized to the specific facts of the proposed JV can allow the partners to implement rules for ending their relationship in a way designed to maximize the value of the JV and reduce uncertainty.

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Understanding the purpose of the JV and the impact of the JV's assets and services on the partners' businesses is critically important to implementing exit provisions that are effective for the partners. For midstream MLPs, the assets of their JVs often become critical to the overall operations of the MLP. If not having access to these assets would significantly impact the MLP's business, it is important for the MLP to negotiate exit provisions that give it the right to continued use of the assets.

Whether such rights include the ability to purchase the interests of its partner in the JV will be impacted by the overall economics of the JV.

Creating a JV that will ultimately become part of an MLP requires sophisticated counsel that understands MLPs and the regulations of the U.S. Securities and Exchange Commission and Internal Revenue Service applicable to MLPs. In order to be effective in representing a client in the JV formation, such counsel should also have a detailed understanding of the way the JV fits into the client's operations and the goals of its client in entering into the JV. ■

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