Expert Q&A on the Delaware Law Amendments Relating to Limited Liability Company Divisions

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An expert Q&A with Tarik J Haskins, Morris, Nichols, Arsht & Tunnell LLP on the Delaware Law Amendments Relating to Limited Liability Company Divisions.

WHAT WERE THE AMENDMENTS TO THE DELAWARE LIMITED LIABILITY COMPANY ACT RELATING TO LIMITED LIABILITY COMPANY DIVISIONS?

On August 1, 2018, the Delaware Limited Liability Company Act (DLLCA) was amended to add, among other things, a division statute (Amendments). The Amendments included new Section 18-217 which permits a Delaware limited liability company (LLC) to divide into two or more LLCs (each a Division company). In a division, the LLC effecting the division (the Dividing company) continues its existence or terminates its existence, as the case may be, as provided in the plan of division.

Under Section 18-217 of the DLLCA, the rules regarding authorization of a division are similar to the rules regarding authorization of a merger under Section 18-209 of the DLLCA. Specifically, Section 18-217(c) of the DLLCA provides that a plan of division is adopted:

- As specified in the Dividing company's limited liability company operating agreement (LLC Agreement).
- If the Dividing company's LLC Agreement does not specify how a division is authorized and does not prohibit a division, then a plan of division is adopted in the same manner that the Dividing company's LLC Agreement requires authorization for mergers and consolidations.
- If the Dividing company's LLC Agreement is silent regarding how mergers and consolidations are authorized and the Dividing company's LLC Agreement does not prohibit mergers, then a plan of division is adopted by members owning more than 50% of the then current percentage or other interest in the profits of the Dividing company.

A plan of division adopted by a Dividing company sets out, among other terms and conditions of the division:

- The treatment of the LLC interests in the Dividing company.
- The allocation of assets, property, rights, series, debts, liabilities, and duties of the Dividing company among the division companies.

On the effectiveness of a division, for all purposes of Delaware law:

- The Dividing company is subdivided into the distinct and independent resulting companies named in the plan of division and the Dividing company survives or ceases to exist as set out in the plan of division (§ 18-217(l)(1) of the DLLCA).
- All of the property, real, personal, and mixed of the Dividing company is allocated to and vested in the applicable Division company in such a manner and basis and with such effect as is specified in the plan of division (§ 18-217(l)(2) of the DLLCA).
- Each Division company is liable as a separate and distinct domestic LLC for the debts, liabilities, and duties of the Dividing company as are allocated to the Division company in the plan of division (§ 18-217(l)(3) of the DLLCA).
- Each of the debts, liabilities, and duties of the Dividing company is allocated to and shall be the debts, liabilities, and duties of the Division company as is specified in the plan of division as having such debts, liabilities, and duties allocated to it, in such manner and basis and with such effect as is specified in the plan of division, and no other Division company is liable for these debts, liabilities, and duties (§ 18-217(l)(4) of the DLLCA).
- All liens on any property of the Dividing company shall be preserved unimpaired (§ 18-217(l)(4) of the DLLCA).

WHAT WAS THE PURPOSE OF THE AMENDMENTS?

The DLLCA is amended annually to ensure that it is the preeminent statute governing LLCs and to ensure that the DLLCA addresses the needs of practitioners and persons using the LLC form, including the needs of M&A practitioners.

For years, M&A practitioners have suggested that a division statute would be a helpful tool to add to their M&A tool box. A division transaction would permit companies to easily spinoff certain lines of business in a simple and straightforward manner.

A division statute similar to Section 18-217 has been in place in Texas and Pennsylvania for several years. In fact, some of our clients that have wanted to use a division transaction have caused their Delaware LLCs to transfer to Pennsylvania, divide into two or more Pennsylvania LLCs under Pennsylvania's division statute, and then re-domesticate back to Delaware. The division statute was therefore added to respond to needs of practitioners and persons using the LLC form and to provide business planners with additional flexibility in managing assets and liabilities.

WHAT PROTECTIONS FOR LENDERS ARE EXPLICITLY INCLUDED IN THE AMENDMENTS?

Under Section 18-217 of the DLLCA, an allocation of debts, liabilities, and duties and assets, properties, and rights is to be respected if the plan of division does not constitute a fraudulent transfer under applicable law. Under the terms of Section 18-217(l)(5) of the DLLCA, if an allocation of debts, liabilities, and duties and assets, properties, and rights set out in a plan of division is determined to be a fraudulent transfer, then under the DLLCA, all of the Division companies will be jointly and severally liable on account of this fraudulent transfer, despite the allocations made in the plan of division. Therefore, if a division constitutes a fraudulent transfer, then a lender can hold the Dividing company and each newly created LLC jointly and severally liable for the fraudulent transfer. Provided, however, the burden will be on the lender to prove the relevant elements of a fraudulent transfer, which may be difficult depending on how the division transaction is structured.

Certain protections are provided to lenders depending on the date of formation of the LLC. If an LLC was formed after August 1, 2018, then the DLLCA does not provide any specific protection beyond the fraudulent transfer protection described above. For LLCs that were formed before August 1, 2018, if this LLC entered into any written contract, indenture or other agreement before August 1, 2018, that "by its terms, restricts, conditions or prohibits (i) the consummation of a merger or consolidation by the dividing company with or into another party, or (ii) the transfer of assets by the dividing company to another party," then this restriction, condition or prohibition is deemed to apply to a division as if it were a merger, consolidation, or transfer of assets, as applicable.

This Section 18-217(o) safe harbor is intended to apply regardless of the governing law clause set out in an applicable written contract, indenture, or other agreement. Therefore, if the two conditions to the applicability of Section 18-217(o) of the DLLCA are satisfied, then a division transaction should be treated like a merger, consolidation, or transfer of assets under the applicable written contract, indenture or agreement and consummation of the division transaction without complying with the contract, indenture, or agreement should constitute a breach under the relevant credit agreement in the same manner that a prohibited merger, consolidation, or transfer of assets would constitute a breach of the credit agreement.

DO EXISTING CREDIT AGREEMENT COVENANTS RESTRICTING TRANSFERS PREVENT LOAN PARTIES FROM DIVIDING INTO MULTIPLE LLCS AND REALLOCATING ASSETS AND DEBT?

Whether existing credit agreement covenants restricting transfers of assets prevent a division and reallocation of assets and liabilities by a Dividing company depends on the precise language of the covenants. However, a plain vanilla covenant in a credit agreement restricting transfers of assets is probably not sufficient to protect lenders.

Under Section 18-217(l)(8) of the DLLCA, the rights and privileges and interests in property and the debts, liabilities, and duties that are allocated to a Division company "shall not be deemed, as a result of the division, to have been assigned or transferred for any purpose of the laws of the State of Delaware." Consequently, the division statute is designed to override a typical covenant restricting transfers of assets. If a credit agreement includes a definition of "transfer" or similar term that is broad enough to cover divisions, then a covenant restricting these broadly defined transfers may prevent a division under Section 18-217 of the DLLCA.

HOW SHOULD NEW CREDIT AGREEMENTS BE REVISED BECAUSE OF THE AMENDMENTS?

Lenders entering into new credit agreements involving Delaware LLCs are well advised to add negative covenant language prohibiting divisions. The new language should require any newly created Division companies resulting from a borrower to become a party to the credit agreement and to pledge its assets under the credit agreement regardless of whether this new Delaware LLC satisfies the definition of "subsidiary" under the credit agreement. In addition, clauses requiring new subsidiaries to guarantee a borrower's obligations (including, for example, further assurances clauses) should be revised to ensure that any newly created Division company shall become a guarantor under the credit documents.

New credit agreements should also define prohibited "transfers of assets" to include an allocation or transfer of assets and liabilities following a division. Finally, new credit agreements should expressly prohibit a division by the borrower and any guarantors. Further, other definitions and provisions in credit agreements should be carefully reviewed to determine whether any modifications to such definitions or provisions are advisable due to the Amendments.

SHOULD EXISTING CREDIT AGREEMENTS BE AMENDED AS SOON AS POSSIBLE TO DEAL WITH THE AMENDMENTS?

Although lenders party to loan documents entered into prior to August 1, 2018 can take some comfort in the safe harbor described above, lenders should carefully review their existing credit agreements to determine whether such credit agreements provide sufficient protection to prohibit a division. As a practical matter, a division constitutes a fundamental transaction that may be prohibited by covenants or other provisions contained in existing credit agreements. The definition of "Events of Default" set out in existing credit agreements may also provide some protection against a division. However, even if an existing credit agreement provides some protection, if divisions are not specifically addressed in the credit agreement, a plan of division may be designed to avoid breaching these covenants or other provisions. Therefore, lenders are well advised to address divisions specifically in their credit agreements to avoid any risk that these covenants or definitions of events of default do not contain sufficient protection.

SHOULD LENDERS REQUIRE BORROWERS TO AMEND THEIR LLC AGREEMENTS TO PREVENT DIVISIONS?

Whether lenders should require borrowers to amend their LLC Agreements to prohibit divisions depends on the relevant facts and circumstances of the credit facility and how much protection a lender desires to have regarding divisions. A lender can gain some protection by including a covenant in a credit agreement prohibiting divisions; however, a lender can obtain superior protection by including a covenant in the borrower's LLC Agreement prohibiting divisions.

The DLLCA expressly permits an LLC Agreement to provide rights to any person, including a person that is not a party to the LLC Agreement (§ 18-101(7) of the DLLCA). Section 18-217(k) of the DLLCA also provides that an LLC Agreement may provide that a LLC does not have the power to divide. Consequently, because the DLLCA has been drafted to allow third parties, such as lenders, to build protections for themselves into an LLC Agreement, lenders should consider requesting amendments to a borrower's LLC Agreement to prevent divisions. Including a prohibition on divisions in an LLC Agreement would make a division transaction an ultra vires action for the LLC as opposed to a breach of a covenant in the credit agreement. As previously discussed, there are degrees of protection that a lender can obtain and including a prohibition on divisions in a borrower's LLC Agreement provides the most protection available to a lender.

BECAUSE OF THE AMENDMENTS, CAN BORROWERS POTENTIALLY CAUSE ISSUES FOR LENDERS BY CREATIVELY USING UNRESTRICTED SUBSIDIARIES OR ADDITIONAL NEWLY FORMED BORROWERS?

Depending on the actual provisions in a credit agreement, borrowers potentially may use a division transaction to cause mischief under a credit agreement. An example of an issue that may arise includes transferring assets to a new Division company that, under the terms of the credit agreement, is not expressly required to become a party to the credit agreement because the credit agreement allows designation of immaterial subsidiaries or unrestricted subsidiaries. Therefore, while the original Dividing company retains the liability, it no longer owns the collateral supporting the loan.

Alternatively, the lender's liability may be allocated to a new Division company that lacks sufficient assets to satisfy the liability. If a borrower transfers property to a Division company and the lender fails to take steps to perfect its security interest in after-acquired collateral, the lender may also be unperfected regarding collateral acquired by this Division company four (4) months after the division. The ability to allocate assets and liabilities to new Division companies in a manner that was not contemplated by the lender may generally create issues for the lender.

RATHER THAN REVISE COVENANTS, CAN LENDERS RELY ON EXISTING CREDIT AGREEMENT PROVISIONS FOR PROTECTION IF THERE WAS A DIVISION AND ASSET TRANSFER?

Whether an event of default for breach of a representation relating to asset ownership or for a material adverse effect may provide sufficient protection depends on the nature of and how the events of default in the credit agreement are drafted. For example, a general representation relating to title to property of a borrower may not be breached by a division if it does not refer to specific property of the borrower or if that property is not tied to the "business" of the borrower, or both. A borrower's representation that it owns a specific piece of real property in fee title without any liens other than permitted liens is probably breached if that real property were allocated to a new Division company.

A representation that a borrower owns marketable title to all the property necessary or desirable for the operation of the business as operated at the closing of the loan is also probably breached if property necessary or desirable to operate the business were allocated to a new Division company. However, if the representation merely states that all the property owned by borrower is owned free and clear of any liens, then that representation may not be breached following a division. The Dividing company still owns whatever property is retained by it free and clear, so the representation is still probably accurate; provided, that, after the division the amount and nature of the property owned by the Dividing company has changed.

If a credit agreement contains a general material adverse effect provision, depending on how the assets and liabilities are allocated in a plan of division, this provision may be used to trigger an event of default following a division. However, whether there has been a material adverse effect can be subjective and the Dividing company may be able to structure the division in a manner in which the collateral supporting the loan has materially changed but not in such a manner that a court would find that the division constitutes a material adverse effect.

CAN THE CREDIT AGREEMENT EFFECTIVELY PROVIDE THAT ANY DIVISION IN VIOLATION OF THE CREDIT AGREEMENT BE NULL & VOID?

Delaware law governs the internal affairs of the Dividing company and addresses whether a division can be consummated. It is unlikely that a Delaware court can find that a provision set out outside of an LLC's constituent documents can override the provisions of the DLLCA and its constituent documents, which by default permit an LLC to enter into a division.

The best protection for a secured lender is to take advantage of Section 18-217(k) of the DLLCA, which allows for an LLC Agreement to prohibit divisions and require as a closing condition that the borrower include a provision in the LLC Agreement that prohibits divisions. If the prohibition is set out in the borrower's LLC Agreement, then a division shall be an ultra vires action as opposed to constituting a breach of the credit agreement.

HOW IS THE DELAWARE SAFE HARBOR APPLICABLE FOR NEW YORK LAW GOVERNED CREDIT AGREEMENTS?

Section 18-217(o) of the DLLCA provides protection to secured lenders if both:

- The relevant LLC was formed before August 1, 2018.
- The relevant LLC is a party to a written contract, indenture, or other agreement entered into before August 1, 2018 that restricts, conditions, or prohibits mergers, consolidations, or transfers of assets.

If both of the conditions described in the preceding paragraph are satisfied, then the relevant restriction, condition or prohibition on mergers, consolidations, and transfers of assets is deemed to apply to a division as if the division were a merger, consolidation, or transfer of assets. The intent of this safe harbor is to provide lenders with the same protection lenders have in their credit agreements regarding mergers, consolidations, and transfers of assets.

This safe harbor is intended to apply to written contracts, indentures, and agreements governed by Delaware law and written contracts, indentures, and agreements governed by non-Delaware law. Consequently, the objective of Section 18-217(o) of the DLLCA is that a court applying New York law as a matter of comity looks to the Delaware statute to determine the nature of the Delaware division statutes and essentially reads the Section 18-217(o) language into any New York law governed credit agreement. Because of reading Section 18-217(o) of the DLLCA into a New York law governed credit agreement, a borrower breaches this provision if it consummates a division without complying with the provision in the credit agreement governing mergers, consolidations, or transfers of assets.

Although Section 18-2017(o) of the DLLCA is intended to provide protection to lenders, it is not clear whether a court applying New York law can interpret the credit agreement to restrict, condition, or prohibit divisions, as required by Section 18-217(o) of the DLLCA. Accordingly we believe that lenders should consider amending their credit agreements to address divisions directly as opposed to relying on Section 18-217(o) of the DLLCA.

IS A NEW UCC-1 FILING REQUIRED OVER THE NEWLY DIVIDED LLC FOR THE LENDER TO MAINTAIN PERFECTION? CAN IT BE AN ALL ASSETS UCC-1 FILING?

Under Section 9-315(a)(1) and Section 9-507(a) of the Uniform Commercial Code (UCC), a lender is not required to file a new UCC-1 financing statement (UCC-1) for each new Division company regarding the property allocated to the Division company. For UCC purposes, the division should be analyzed as a disposition of collateral and as a disposition of collateral, the lender should generally remain perfected in the existing collateral without further action. A lender, however, must file a new UCC-1 to perfect a security interest in the Division company's collateral that is acquired four (4) months after the division. The division statute does not affect UCC rules regarding descriptions of collateral in a financing statement. Therefore, an all assets filing for each new Division company is acceptable.

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