

Divide and Conquer!

Statutory Divisions of LLCs and Limited Partnerships Under Delaware Law

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A powerful new tool was recently added to the toolbox of Delaware entity practitioners. In 2018, the Delaware Limited Liability Company Act (the “Delaware LLC Act”) was amended to add Section 18-217, which authorizes a Delaware limited liability company (an “LLC”) to divide its assets and liabilities into two or more LLCs pursuant to a plan of division. In 2019, the Delaware Revised Uniform Limited Partnership Act (the “Delaware LP Act”) followed suit by adding Section 17-220, which allows a Delaware limited partnership (a “Limited Partnership”) to divide into two or more Limited Partnerships. It is important that those who deal with Delaware LLCs and Limited Partnerships, including lenders, are aware of the new division statutes, both to be able to take advantage of the opportunities they create but also to protect against the potential consequences of a division.

Effecting the Division

We begin by describing how a division works. In simple terms, it is essentially the opposite of a merger, in which one or more entities merge into another entity, with the result being that multiple entities are now a single entity. A division, on the other hand, begins with a single entity and results in multiple entities.

A simple example will help illustrate this concept. Let’s say that an LLC holds two primary assets, a shopping center and a hotel, and wants to sell the hotel but retain the shopping center. For tax, regulatory or other reasons, the proposed buyer of the hotel wants to purchase the entity that owns the hotel rather than purchase the individual assets that comprise the hotel, but the proposed buyer does not want to buy the shopping center or the LLC in which the shopping center is held. A division could be used to move the hotel into a separate, new LLC, while the shopping center remains in the original LLC, and the buyer could then purchase the interests in the new LLC.

Under the Delaware LLC Act, the “dividing company” is the LLC that is effecting the division and the “division company” is (a) each new LLC that is formed as

a result of the division and (b) if the original LLC survives the division, the original LLC. Under the Delaware LP Act, the “dividing partnership” is the Limited Partnership that is effecting the division and the “division partnership” is (a) each new Limited Partnership that is formed as a result of the division and (b) if the original Limited Partnership survives the division, the original Limited Partnership. For purposes of simplicity, we use the term “dividing company” to refer both to a dividing LLC under the Delaware LLC Act and a dividing Limited Partnership under the Delaware LP Act and “division company” to refer both to a division company under the Delaware LLC Act and a division partnership under the Delaware LP Act. The dividing company can either continue its existence or terminate as a result of the division. A division of an LLC or a Limited Partnership is effected by (i) the adoption of a plan of division by the dividing company and (ii) the filing with the Delaware Secretary of State of a certificate of division and, in the case of the division of an LLC, a certificate of formation for each newly formed LLC and, in the case of the division of a Limited Partnership, a certificate of limited partnership for each newly formed Limited Partnership. Similar to a merger agreement with respect to a merger, a plan of division is the fundamental agreement with respect to a division that sets forth the terms and conditions of the division, including, importantly, how the assets, property, rights, series, debts, liabilities and duties of the dividing company will be allocated among the division companies. The plan of division also specifies what happens to the interests in the dividing company upon the division. For example, the interests in the dividing company may remain outstanding, may be converted into or exchanged for interests in one or more division companies, may be converted into cash, property or rights or securities or obligations of or interests in any other entity that is not a division company or may be canceled, or any combination of the foregoing. The plan of division can also include any other matters that the dividing company determines to include in it.

A certificate of division is the document that is filed with the Delaware Secretary of State to effect the division. It includes high-level information, such as (i) the name of the dividing company and whether it will survive the division, (ii) the name of each division company and (iii) the name and business address of the division contact, which is a person who is required to maintain a copy of the plan of division for a period of 6 years following the division. The division contact is required to provide a copy of the plan of division, without cost, to any creditor of the dividing company. A division becomes effective immediately upon the filing of a certificate of division with the Delaware Secretary of State unless the certificate of division specifies a future effective time.

Approvals Required for a Division

To determine the approvals required to authorize a division of an LLC or a Limited Partnership, one must first look to the provisions in the limited liability company agreement of the LLC or the limited partnership agreement of the Limited Partnership (the “Company Agreement”). If the Company Agreement specifies the manner of approval required for a division, then that provision will govern. If the Company Agreement does not specify the manner of approval required for a division, and does not prohibit a division, but does specify the manner of

approval required for a merger or consolidation, the approval required for a division is the same as the approval required for a merger or consolidation. If the Company Agreement does not specify the manner of approval required for a division, merger or consolidation and does not prohibit division, the division must be approved, in the case of the division of an LLC, by members who own more than 50% of the interest in the profits of the LLC or, in the case of the division of a Limited Partnership, by all the general partners of the Limited Partnership and by limited partners who own more than 50% of the interest in the profits of the Limited Partnership.

Effects of a Division

When a division occurs, the division companies resulting from the division are separate and distinct LLCs or Limited Partnerships. All of the property rights, privileges and powers and all debts and liabilities of the dividing company are allocated to and vested in the division companies pursuant to the plan of division, without any further actions. If any debts, liabilities and duties of the dividing company are not allocated in the division, they become joint and several liabilities of all of the division companies so it is important for the plan of division to address the allocation of all debts, liabilities and duties to avoid this result.

Importantly, the rights, privileges, powers and interests in property of the dividing company and debts, liabilities and duties of the dividing company allocated to a division company are not deemed to have been assigned or transferred for purposes of Delaware law. Thus, subject to one exception we will describe below, a typical restriction on the assignment or transfer of assets in a contract with a dividing company likely would not restrict an allocation of those assets to a division company in a division. Similarly, all liens upon any property of the dividing company are preserved unimpaired, and all debts, liabilities and duties of the dividing company remain attached to the division company to which those debts, liabilities and duties have been allocated in the plan of division, and may be enforced against the division company to the same extent as if such debts, liabilities and duties had originally been incurred or contracted by such division company in its capacity as an LLC or Limited Partnership.

In light of the ability in a division to divide up the assets and liabilities of the dividing company among division companies, one obvious concern is whether a division can be used to avoid fraudulent transfer laws. The answer is no. If a division constitutes a fraudulent transfer, each division company resulting from the division is jointly and severally liable for any liabilities on account of the fraudulent transfer notwithstanding the allocation made in the plan of division. For example, if an LLC were to do a division in which it allocated all of its assets to one division company and allocated all of its liabilities to another division company, which allocation would presumably constitute a fraudulent transfer, both division companies would be jointly and severally liable for the liabilities of the dividing LLC and thus creditors of the dividing LLC who were victimized by the fraudulent transfer should have recourse against the same assets of the dividing LLC, now held in division companies,

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to which they had recourse prior to the division. To avoid the potential uncertainty and complexities that would result from attempting to “undo” a division that has occurred but is later found to constitute a fraudulent transfer, a division remains valid and effective even if it is determined to result in a fraudulent transfer, but, as discussed above, subject to the imposition of joint and several liability among the division companies.

Another significant feature of a division is that it can effect an amendment to the Company Agreement of the LLC or Limited Partnership or adopt a new Company Agreement, without regard to the vote otherwise required to amend the provisions of the Company Agreement unless the amendment provisions of the Company Agreement specifically restrict amendments by division, merger or consolidation. For example, if the Company Agreement of an LLC provides that the unanimous vote of the members is required to amend the provisions of the Company Agreement but does not specifically address amendments in connection with a division, merger or consolidation and the Company Agreement is silent with respect to the vote required to approve a division of the LLC, the LLC may be divided, and the LLC Agreement of the LLC may be amended as part of that division, with a vote of the members who own more than 50% of the interest in the profits of the LLC.

Implications for Lenders

Prior to the adoption of the division amendments to the Delaware LLC Act and the Delaware LP Act, most loan documents did not explicitly restrict, condition or prohibit divisions, as the concept of a statutory division only existed in a few jurisdictions. To protect lenders and others who entered into contracts with LLCs and Limited Partnerships prior to the adoption of the division amendments, a provision was included in the Delaware LLC Act and Delaware LP Act providing that any written contract, indenture or other agreement entered into prior to the effective date of the division amendments (August 1, 2018 with respect to LLCs and August 1, 2019 with respect to Limited Partnerships (as applicable, the “Effective Date”)) that by its terms restricts, conditions or prohibits an LLC or Limited Partnership formed on or before such Effective Date from (x) consummating a merger or consolidation with or into another party or (y) transferring assets, such restriction will be deemed to apply to a division as if it were a merger or consolidation or asset transfer. Thus, if a loan agreement entered into before August 1, 2018 restricts an LLC formed prior to August 1, 2018 from merging, consolidating or transferring its assets, such LLC would also be restricted from dividing.

However, in entering into a loan agreement with any LLC or Limited Partnership formed on or after the applicable Effective Date or entering into a loan agreement on or after the applicable Effective Date with an LLC or Limited Partnership, a lender should consider including restrictions or conditions on the ability for the LLC or Limited Partnership to divide. Otherwise, the debtor could effectuate a division that allocates assets to a non-debtor or allocates the loan to a new LLC. While, as discussed

above, a lender is protected against a division that constitutes a fraudulent transfer, allocation of the loan or assets away from the original debtor could reduce the creditworthiness of the debtor, could affect the collateral or other security for the loan or could have other undesirable consequences for a lender. In the event a division occurs with respect to an LLC or Limited Partnership that is a debtor, it is valuable to remember that a creditor can request, without cost, a copy of the plan of division from the division contact during the six-year period following the division.

Conclusion

The amendments to the Delaware LLC Act and the Delaware LP Act offer increased flexibility to entity practitioners to address circumstances that call for restructuring how the assets and liabilities of an LLC or Limited Partnership are held without having to resort to a merger or transfer of assets. They are yet another example of Delaware entity law remaining on the cutting edge.



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