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SECURED TRANSACTIONS

Dividing Delaware LLCs

By Barbara M. Goodstein And Jennifer Kratochvil

Most financing agreements have covenants limiting the ability of a borrower to merge, consolidate, create subsidiaries, declare and pay dividends or other "restricted payments," or transfer assets. However, certain states, most recently Delaware, have created a new type of corporate action that permits certain borrowers to reorganize in a way that may not be captured by existing covenants.

Section 18-217 of the Delaware Limited Liability Company Act went into effect on Aug. 1, 2018. This section allows a Delaware limited liability company to divide into two or more separate Delaware limited liability companies, and is intended to facilitate asset transfers without requiring separate asset transfer agreements. The statute contains fairly clear and straightforward steps to accomplish a "division" (often counter-intuitively referred to by commentators as a "divisive merger"). It also raises a number of questions.

The concept is very meiosis-like (remember your high school biology?). The statute contemplates an original "*dividing company*" that may or may not be a "surviving company" after the division, but further that there will be at least one "*resulting company*" that will be a distinct and different entity from the dividing company. Each of the foregoing will be referred to as a "*division company*." Sound confusing?

Questions such as what happens to security interests on existing assets, whether provisions in existing financing agreements should be amended and what should be done in regard to new agreements need to be addressed by creditors in the wake of this new legislation. Today we briefly examine the legislation and discuss those concerns.

The New Statute—Basics

Section 18-217 applies to all Delaware LLCs, although there is a safe harbor (discussed below) for LLCs that are both in existence and party to a financing agreement entered into prior to August 2018. Similar to other corporate reorganization statutes, §18-217(g) requires the division to be effectuated through a plan—in this case a plan of division. The plan of division must set forth the allocation among the division companies and reasonably identify (in a way that's objectively determinable) the assets and liabilities of the dividing LLC to be allocated. It must state whether the existing LLC will continue in existence or terminate and, if the former, its name post-division, as well as the names of each resulting LLC. It must also specify the name and address of a "division contact," which should be either a Delaware resident or Delaware-organized entity. The division contact must maintain a copy of the plan of division for six years after the division effective date and provide to any creditor of the dividing company without cost, within 30 days of receipt of a written request, the name and business address of the division company to which such creditor's

BARBARA M. GOODSTEIN *is a partner and* JENNIFER KRATOCHVIL *is a counsel in the finance department at Mayer Brown.*

claim was allocated pursuant to the division plan.

While the plan of division need not be publicly filed, a certificate of division must be filed with the Delaware Secretary of State which includes the division contact, along with a certificate of formation for each resulting company LLC. All such certificates must have the same effective time. If the dividing company does not survive the division, the certificate of division acts as a certificate of cancellation.

A resulting company LLC is responsible only for the debts and liabilities allocated to it. However, if a court determines that the allocation of debts, duties, and liabilities constituted a fraudulent transfer, then each division company is jointly and severally liable for such obligations, notwithstanding such allocation (although the plan itself remains effective). Also, any liabilities not allocated by the plan of division are joint and several liabilities of all of the division companies.

If the asset of a dividing company is subject to a lien, the statute specifies that such lien will survive unimpaired when that asset is allocated to a resulting LLC (see §18-217(l)(4)).

Things to Think About

What should creditors of Delaware LLCs be concerned about in light of this new statute?

Most finance agreements do not specifically address the concept of a "division." One may think that a division is subject to covenants restricting asset transfers without express reference to divisions. However, there are indications in the statute that this may not be the case.

First, at least for existing finance agreements, §18-217(o) of the Delaware LLC Act provides an express safe harbor for LLCs in existence prior to August 2018. It specifies that if such a dividing LLC is party to a contract entered into prior to August 2018 that restricts the consummation of a merger or consolidation or the transfer of assets, then such restrictions shall be deemed to apply to a division as if it were a merger or consolidation or a transfer of assets.

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In addition, §18-217(l)(8) states that the rights, privileges, powers and interests in property of a dividing company that have been allocated to a division company are not deemed, as a result of the division, to have been assigned or transferred to such division company for "any purpose of the laws of the State of Delaware."

These two provisions collectively suggest that there is a risk in considering an assignment or transfer to include a division, so finance agreements entered into on or after Aug. 1, 2018 should separately prohibit divisions and not rely solely on restrictions on assignments.

Notably, the safe harbor in §18-217(o) also does not apply to Delaware subsidiaries that are joined to finance documents on or after Aug. 1, 2018. For example, if a Delaware LLC was in existence prior to that date but was an unrestricted subsidiary and therefore not subject to the covenants of its parent's loan agreement, then it would not have the benefit of the safe harbor when it became a party to its parent's loan agreement as a restricted subsidiary because it was not party to the loan agreement as of Aug. 1, 2018.

It is possible, however, that as part of a division encumbered assets may remain with or be allocated to one division company while the related liabilities are allocated to a different one. If the value of the assets transferred exceeds the amount of liabilities, the Delaware division statutory protections against fraudulent transfer may not apply; nevertheless, a division company may assume liabilities to a creditor without acquiring the assets that secure those liabilities. Since LLC divisions allow borrowers to divide into multiple LLCs, a borrower could effectively create a structure where its assets belong to one LLC (which might not be a borrower or loan party) and the

related liabilities and obligations are allocated to another LLC borrower/loan party.

To address these situations and avoid these results, a creditor should ensure that (1) covenants limiting or prohibiting mergers, consolidations, transfers of assets, dividends and investments also limit or prohibit divisions and (2) covenants that require newly formed or acquired entities to be joined to the credit agreement as loan parties and to pledge their assets apply to entities resulting from divisions.

As discussed above, it is possible for a resulting company LLC that is not party to a security agreement to be allocated an asset pledged pursuant to such security agreement. Under the transfer rules in UCC §§9-315, 9-316, 9-325 and 9-507(a), and the Delaware division statute, the asset would remain subject to such lien. However, the assets of the resulting company LLC that arise *after* the division will *not* be subject to a lien unless the resulting company LLC becomes bound by the security agreement and the secured party files a UCC financing statement against the resulting LLC in respect of the after-acquired assets. Accordingly, finance agreements should require notice of any division (in addition to notices of name changes) so that, among other things, UCC filings can be made to continue perfection of a lien on assets acquired by a new debtor.

Much of the focus of late has been on the new Delaware LLC division statute, but three states, Texas, Arizona and Pennsylvania, already allow for LLC divisions. In each of these states, divisions actually are permitted for all forms of business entities, not just limited liability companies. In Texas (thought to be the source of the term “divisive merger”), a “merger” is defined to include “the division of a domestic entity into two or more new domestic entities or other organizations or into a surviving domestic entity and one or more new domestic or foreign entities or non-code organizations.”

While Delaware has so far only adopted a division process for limited liability companies, parties entering into new finance agreements with other types of Delaware entities should consider expanding their covenants and notice requirements to include divisions.

(Texas Business Organizations Code §1.002(55)(A)). Arizona provides a division process (29 Ariz. Rev Stat. §2601 et seq.) that has some key differences from the Delaware statute. Notably, Arizona’s statutes provide additional protections for creditors by specifying that obligations existing prior to a division are joint and several liabilities of all of the division entities, and creditors have a consent right to allocation of obligations (29 Ariz. Rev Stat. §2607). Pennsylvania’s division process (15 Pa. Consol. Stat. §361 et seq.) binds each resulting entity to any pre-existing security agreement that attaches to after-acquired collateral, notwithstanding the division plan to the contrary (15 Pa. Consol. Stat §368(h)). Delaware law, by contrast, does not provide for the resulting LLCs to be bound by such a security agreement.

Conclusion

The new Delaware division statute will likely provide efficiencies for corporate transfers and other transactions, but creditors need both to consider their existing finance agreements and be mindful in documenting new transactions of the effect of this new legislation in regard to limitations on such transfers and other transactions.

While Delaware has so far only adopted a division process for limited liability companies, parties entering into new finance agreements with other types of Delaware entities should consider expanding their covenants and notice requirements to include divisions. The likelihood exists that this concept may be expanded in the not-too-distant future beyond just limited liability companies.

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