Divisive Mergers and Impact on Fund Financings

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Introduction

Private equity and other types of investment funds ("Funds") often utilize financing to more quickly access funds for investments, working capital and other purposes. Such financing products include both facilities secured by a Fund's investment assets or the net asset value of the equity in such assets ("NAV Facilities") and subscription-backed credit facilities. Subscription-backed credit facilities, sometimes referred to as "capital call" or "capital commitment" facilities (each a "Subscription Facility" and together with NAV Facilities, "Facilities"), are secured by pledges of the contractual rights of the Fund to require its investors to pay in capital to the Fund from time to time, which rights arise from the Fund's organizational documents. The ability of a Fund to utilize such Facilities and the extent to which the contemplated security for a particular Facility is feasible requires careful review and consideration of the Fund's governing agreement, usually a limited partnership ("LP") or limited liability company ("LLC") agreement.

While prior issues of the *Market Review* discussed updates in technology relating to Series LPs and LLCs and their impact on Facilities, this article focuses on recent changes in the laws relating to business entities that permit such entities to consummate transactions informally known as divisive mergers (each, a "Divisive Merger"). Such Divisive Merger statutes permit business entities to divide into multiple entities and to allocate liabilities and assets of the dividing entity amongst surviving entities. While other states were first in passing Divisive Merger statutes, this article focuses mainly on the recent changes in Delaware law, as most Funds organized in the United States are formed in Delaware.

Because Divisive Mergers permit business entities to restructure their assets and liabilities more easily, they can create problems for lenders ("Lenders") in Facilities if the effect of Divisive Mergers is not properly considered and accounted for in Facility documentation. In particular, Divisive Mergers may impact Lenders in existing Facilities, as obligors thereunder could potentially allocate liabilities relating to a Facility to other successor entities. Additionally, this could affect the status of capital commitments or asset security for Facilities should such assets be re-allocated to entities that are not obligors. Accordingly, it is important for Lenders and Funds to understand this new technology in order to assess the impact on existing Facilities and to properly conduct due diligence and document new Facilities. This article includes a summary of the changes in law surrounding Divisive Mergers, a discussion of the impact of this new technology on existing credit agreements and a review of considerations for improved diligence and loan documentation moving forward.

Background of Divisive Mergers

The first Divisive Merger statute was passed in Texas in 2006 and related to limited liability companies, limited partnerships, corporations and any other business entity organized in Texas.[1] Divisive Mergers, initially unique to Texas but which were also implemented by Arizona and Pennsylvania in 2016,[2] permitted such entities additional, flexible restructuring options. For example, such statutes permit business entities to reorganize their assets and liabilities for a number of purposes. Such purposes may include efficient division of entities to end a partnership where equity holders are unable to effectively work together, to spin off certain assets or liabilities so as to restructure an entity's balance sheet or to assign contracts that may otherwise be unassignable. Where used to facilitate asset transfers, such statutes permit LLCs to achieve such objectives without having to execute numerous transfer agreements and potentially without violating transfer restrictions included in the contracts that the dividing LLC may wish to reallocate.[3] Not to be outdone, in August 2018, Delaware followed suit by enacting changes to the Delaware Limited Liability Company Act (the "LLC Act"), which permit limited liability companies organized in Delaware (a "Delaware LLC") to divide and allocate assets and liabilities to one or more newly formed Delaware LLCs (such amendments, the "Amendments").[4]

Plan of Division

Pursuant to the Amendments, an existing Delaware LLC (the "Dividing Company") may divide its "assets, property, rights, series, debts, liabilities and duties" among itself (if the Dividing Company is intended to survive the Divisive Merger) and any new Delaware LLCs that are created in connection with such Divisive Merger ("Resulting Companies," and together with any Dividing Company that survives, the "Division Companies").[5]

The Amendments provide that a Dividing Company may only affect a division through a plan of division (a "Plan").[6] A Plan is required to set forth the terms and conditions of the Divisive Merger, including information as to how the limited liability company interests of the Dividing Company will be treated in connection with the Divisive Merger (e.g., conversion, exchange or cancellation of such interests) and the allocation of "assets, property, rights, series, debts, liabilities and duties" of the Dividing Company among the Division Companies.[7] The Plan is also required to include the names of each entity that survives the Divisive Merger, the name and business address of a division contact who maintains a copy of the Plan (a "Division Contact") and other matters which the Dividing Company chooses to include.[8] A Plan is not required to list each individual asset and liability of the Dividing Company that is to be allocated, so long as such assets and liabilities are "reasonably identified" by any method where the identity of such assets and liabilities is "objectively determinable."[9] While the Plan is not filed with the State of Delaware and, therefore, would not be obtained through a search of the company records, a certificate of division ("Certificate") is required to be filed by "the surviving company" if there is one, or any other Division Company.[10]

A Certificate is more basic than a Plan and provides only limited information about the Division Companies, such as the names and addresses of the surviving Division Companies, any prior names of the Dividing Company and a statement that the Plan is on file at a place of business of a specified Division Company, with such Division Company's address.[11] The Certificate also provides the name and business address of the Division Contact.[12] The Amendments require that such Division Contact be a resident of Delaware (or an entity organized in Delaware), maintain a copy of the Plan for six years post division and provide copies of the Plan to "any creditor" of the Dividing Company during such six-year period upon 30 days' notice.[13] Additionally, the Division Contact must provide the name and address of the Division Company to which a claim of a creditor of the Dividing Company was allocated pursuant to the plan of division.[14]

The Amendments also provide default rules for what types of consents must be obtained in connection with a Divisive Merger and adoption of a Plan, to the extent that such consent requirements are not specified in the limited liability company agreement of a Dividing Company.[15] If a limited liability company agreement specifies consent or other requirements with respect to mergers or consolidation, then a Divisive Merger and a Plan shall be authorized in the same manner.[16] If the limited liability company agreement is otherwise silent, a Plan must be authorized by the approval of "members who own more than 50 percent of the then current percentage or other interest in the profits of the dividing company owned by all of the members."[17]

Allocation of Assets and Liabilities and Potential Risks to Lenders

The LLC Act provides that the "debts, liabilities and duties" (collectively, the "Liabilities") of the Dividing Company will be allocated to and be the Liabilities of the Division Company as allocated in the Plan.[18] Additionally, the statute provides a default rule, such that in the event that a particular Liability of the Dividing Company is not specifically allocated by the Plan, post division such Liability is considered to be a Liability of all of the Division Companies on a joint and several basis.[19]

A Dividing Company could therefore fully pass along its obligations under a Facility to a Division Company and would no longer be liable under such Facility, unless the allocation constituted a fraudulent transfer. Due to the fact that liabilities of the Dividing Company are not automatically joint and several obligations of all of the Division Companies, a Lender in a default scenario might have to institute multiple enforcement actions against multiple entities that are each severally liable for a portion of the Liabilities in favor of the Lender. The LLC Act also provides that Liabilities allocated under the Plan will be enforceable against the Division Company to which they are allocated unless the Plan would constitute a fraudulent transfer under applicable law.[20] If a court of competent jurisdiction determines that the related allocation under a Plan constitutes a fraudulent transfer, a similar default rule provides that the Liabilities will be the joint and several obligations of, and enforceable against, all of the Division Companies.[21]

The collateral that is at the heart of a Facility could be impacted by a Divisive Merger. Because a Dividing Company can allocate its assets to new Division Companies, the portfolio investments, portfolio company equity and bank accounts that secure a NAV Facility could be allocated to a new entity through a Divisive Merger. Since the Amendments provide that assets subject to an allocation shall "not be deemed, as a result of the division, to have been assigned or transferred," general transfer restrictions in a NAV Facility credit agreement may not be violated by a Divisive Merger.[22] Similarly, if ownership interests are canceled or converted into cash or other property as the Amendments contemplate, the rights of a Lender in a NAV Facility to collateral consisting of equity interests in portfolio companies could also be fundamentally altered.

Divisive Mergers may also impact Subscription Facilities given the ability to broadly reallocate "rights," "powers" and "interests" of a Dividing

Company, including the various contractual rights that a Fund has through its constituent documents and subscription agreements to call capital from investors and exercise remedies against investors.[23] Moreover, the Amendments also allow the "rights or securities of, or interests in" the Dividing Company to be canceled or "exchanged for or converted into cash, property, rights or securities of, or interests in" a Division Company or even in "any other business entity which is not a division company."[24] It appears that LLC interests of investors in a Dividing Company can therefore be reorganized through a Plan in such a way as to adversely affect Lenders. For example, a reallocation of the equity in a Fund to one or more Division Companies may also mean that the investor's obligations to make capital contributions in relation to their equity interests may be diminished or eliminated or do not carry over to the entities to whom the Liabilities under the Facility are allocated.

We note that, while the Amendments do not permit actions that would cause a fraudulent transfer and may limit the ability of a Plan to adversely affect Lenders, Lenders should nonetheless be concerned with the effect of asset allocations that can be effectuated as it is possible that such allocations may not rise to the level of a fraudulent transfer.

Updates to Diligence/Liens

Another area in which Lenders could be negatively affected by a Divisive Merger would be with respect to the preservation of Liens. Here the Amendments do seem to have Lenders in mind as they provide that "all liens upon any property of the dividing company shall be preserved unimpaired," and all Liabilities of the Dividing Company "shall remain attached" to the Division Company to which such Liabilities have been allocated in the plan of division (the "Lien Clause").[25]

While the Amendments provide that a Lender's security interests will be unimpaired following a Divisive Merger, it does not appear that any revisions to the Delaware Uniform Commercial Code (the "UCC") were made in connection with the Amendments. Therefore, it remains to be seen how the Lien Clause and the UCC's provisions will work together in practice. In this regard, both existing security interests and the due diligence a Lender would perform for new transactions involving a Delaware LLC should be considered.

Properly conducted UCC searches should reveal the existence of prior liens against most types of collateral pledged by a Delaware LLC. However, if an entity has undergone a Divisive Merger or is newly formed as a result of a Divisive Merger, unless new UCC financing statements were filed in connection with a Divisive Merger, typical UCC searches would not reveal liens that continue pursuant to the Lien Clause. Therefore, Lenders conducting due diligence may need to inquire of the borrower whether any LLCs are Division Companies and also perform searches of any filings of a Division Company relating to a Fund that are on file with the State of Delaware ("Delaware Searches") as early as possible in the diligence process. Delaware Searches may reveal the filed Certificate in the event that a Fund was a Dividing Company or, if the Dividing Company did not survive, that it is a Division Company created from a Divisive Merger. We note that the wording of the Amendments suggests that the Certificate may not be filed by all Division Companies.[26] Accordingly, it is important for lenders to request a full certified history of a Delaware LLC's filings with the State of Delaware and not just a certified copy of a Delaware LLC's certificate of formation. A full certified history should include a copy of any Certificate that may be on file for any Division Company, however the certificate of formation may not necessarily include the Certificate. In each case, if an LLC is a Division Company, the Lender should obtain a copy of the Plan to understand the precise division of assets and liabilities relating to such potential obligor. As the Amendments only contemplate the Division Contact being required to provide a copy of the Plan to "any creditor of the dividing company,"[27] it is possible that the Division Contact may not be required to provide such information to a potential Lender. Therefore, it would also be prudent for prospective Lenders to require the potential obligor to make representations as to its status as a Division Company and provide a copy of the Plan that it should represent is the Plan filed with the Division Company (which Plan may be verified by the Division Contact once the Lender becomes a creditor).

A prudent lender will perform UCC searches against the Dividing Company and all Division Companies.[28] We note that, although it is unclear whether new UCC financing statements would need to be filed or current UCC financing statements would need to be amended to account for the changes made by a Plan, the UCC also provides that unless released, a filed financing statement will remain effective with respect to collateral that is "sold, exchanged, leased, licensed or otherwise disposed of," even if the secured party knows of or consents to the disposition. However, if the name of the debtor on a filed financing statement becomes inaccurate so that the financing statement becomes "seriously misleading," the financing statement will only be effective to perfect a security interest in collateral acquired by the new debtor before, or within four months after, the filed financing statement becomes seriously misleading.[29] This uncertainty means that to the extent an existing obligor for a Facility is a Division Company, it would be prudent to make appropriate amendments to UCC financing statements or file new UCC financing statements to clarify the collateral for a Loan.

Updates to Credit Agreements and Loan Documents

The Amendments provide a safe harbor for written contracts in existence prior to the Amendments' effective date. If the applicable contract by its terms "restricts, conditions or prohibits the consummation of a merger or consolidation by the dividing company with or into another party, or the transfer of assets by the dividing company to another party," then such restrictions are also deemed to apply to a Divisive Merger.[30] While this safe harbor should provide protection for older Facilities, new Facilities going forward should be updated to account for Divisive Mergers. Lenders should review and consider the following provisions in Facility documentation taking effect following the Amendments:

MERGERS/CHANGE OF CONTROL PROVISIONS/ASSET TRANSFERS

Divisive Mergers may affect a Lender's rights against an obligor as well as its rights in respect of collateral, the effect of which would be different than a typical merger, whereby the successor company succeeds to the liabilities of the companies being merged.

However, most restrictions on changes of control and transfers of assets in Facilities relate to a traditional merger scenario, restricting only mergers or similar transactions where the original credit party is not the surviving entity. Such restrictions may not apply to transactions relating to a Divisive Merger, and the applicable events of default or mandatory prepayments might not be triggered. It is important for Lenders to review their forms and to incorporate tailored provisions to restrict Divisive Mergers. Restrictions on asset transfers and disposals and changes in control in new credit agreements will need to be updated to specifically reference transactions occurring by way of Divisive Mergers.

NOTICE PROVISIONS/FURTHER ASSURANCES

Notice covenants should be updated to require prompt notice to Lenders in the event that a Divisive Merger is contemplated and provide for necessary Lender approvals (and/or the addition of new Division Companies as obligors) to prevent adverse effects upon a Lender. Further assurance provisions should also be updated to ensure that the Fund will allow the Lender to file any necessary financing statements to ensure that the Lender is kept in the same position from a security standpoint prior to any Divisive Merger. While not covering all of the suggestions above, the Loan Syndications and Trading Association has published model credit agreement language aimed at clarifying that assets, rights and liabilities passed to a different entity through a Divisive Merger shall be deemed to have been transferred.[31]

MATERIAL AMENDMENTS

Facilities also often include provisions relating to material amendments to the constituent documents of a Fund and related entities that may be subject to review and consent of the requisite Lenders. Such material amendments might typically include amendments that affect the rights and duties of a Fund's investors in Subscription Facilities to make capital contributions and the valuation of a Fund's portfolio investments in NAV Facilities. The Amendments state that a plan of division may affect any amendment to the limited liability company agreement of the Dividing Company if it is a surviving company in the division.[32] Material amendment provisions in a credit agreement may (or may not), as drafted, also cover changes that would need to be effectuated post division to effectuate a Plan. It may also be prudent to specify in a Facility credit agreement that any changes to constituent documents relating to a Divisive Merger that could adversely affect Lenders shall be considered to be material amendments to the constituent documents of a Fund and would therefore require Lender review and approval. The Amendments also state that any amendment to a limited liability company agreement or adoption of a new limited liability company agreement for a Dividing Company shall be effective notwithstanding any provisions in the Dividing Company's operating agreement that restrict amendments of the operating agreement, unless such restriction specifically contemplates amendments in connection with a "division, merger or consolidation."[33] The Amendments, therefore, allow for the limited liability company agreements of Dividing Companies to disallow the consummation of a Divisive Merger. Lenders in Facilities conducting due diligence may, in the future, begin checking whether a Fund's organizational documents specifically state that the Fund may not engage in a Divisive Merger.

JOINDER OF DIVISION COMPANIES

In addition, due to the fact that assets may be allocated to Division Companies that are not party to the security agreements in a Facility, in order to ensure that a Lender will have a security interest in any after-acquired assets of such a Division Company, Lenders should also consider whether to add covenants requiring that such Division Companies will become party to the security documents in a Facility if such Facility documents do not otherwise address this issue.

Conclusion

While the ability to divide their assets and liabilities will provide welcome flexibility for Delaware LLCs that wish to restructure in the manner that is most efficient for them, this flexibility provides challenges for Lenders in Facilities. Lenders should ensure that credit agreements are updated to account for Divisive Mergers so that they are adequately protected. Additionally, while Delaware so far has limited this ability to divide to entities formed as limited liability companies, other states that allow Divisive Mergers, such as Texas, Arizona and Pennsylvania, have permitted a broader set of entity types to take advantage of this right.[34] The changes to the LLC Act should therefore be considered in light of the fact that similar changes may be instituted in the future for Delaware limited partnerships, which are even more commonly utilized by borrowers in Facilities than Delaware LLCs.

Endnotes

1 See Texas Business Organizations Code §1.002(55)(A).

2 See 29 Ariz. Rev. Stat. §2601 et seq. and 15 Pa. Cons. Stat. Subchapter F.

3 See Delaware LLC Act §18–217(l)(8) and §18–217(o) (providing that an allocation of assets as part of a Divisive Merger will not be deemed a "transfer" and that a contract that a Delaware LLC is party to that restricts transfers of assets will only be deemed to apply to a Divisive Merger as if it was a transfer of assets if such contract was entered into prior to August 1, 2018).

4 See Delaware LLC Act §18–217.

5 Delaware LLC Act §18–217(g)(1)(b).

6 Delaware LLC Act §18–217(g).

7 *Id*.

8 *Id*.

9 Delaware LLC Act §18–217(l)(7).

10 Delaware LLC Act §18–217(h).

11 *Id*.

12 Delaware LLC Act §18–217(h)(4).

13 Delaware LLC Act §18–217(g)(3).

14 *Id*.

15 See Delaware LLC Act §18–217(c).

16 *Id*.

17 *Id*.

18 Delaware LLC Act §18–217(l)(4).

19 Delaware LLC Act §18–217(l)(6).

20 Delaware LLC Act §18-217(l)(4).

21 Delaware LLC Act §18-217(l)(5).

22 Delaware LLC Act §18-217(l)(8).

23 *Id*.

24 Delaware LLC Act §18-217(e).

25 Delaware LLC Act §18-217(l)(4).

26 Delaware LLC Act §18-217(h).

27 Delaware LLC Act §18–217(g)(3).

28 Delaware Uniform Commercial Code § 9-507(a).

29 Delaware Uniform Commercial Code § 9-506(c).

30 Delaware LLC Act §18-217(o).

31 See LSTA Publishes Divisions by Delaware LLCs Market Advisory (available at: https://www.lsta.org/news-and-resources/news/lsta-publishes-divisions-by-delaware-llcs-market-advisory).

32 Delaware LLC Act §18-217(f)(1).

33 Delaware LLC Act §18–217(f).

34 See Texas Business Organizations Code §1.002(55)(A); and 29 Ariz. Rev. Stat. §2601 et seq. and 15 Pa. Cons. Stat. Subchapter F.