KIBBE & ORBE LLP

Client Alert

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Lenders Beware: Division in Delaware

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Recent amendments to the Delaware Limited Liability Company Act (the "DLLCA") should prompt lenders to take a closer look at their credit agreements and indentures and consider whether updates to those agreements are necessary. Effective August 1, 2018, a Delaware limited liability company (an "LLC") may divide itself into two or more LLCs and allocate the assets and liabilities of the dividing LLC among itself and/or the newly formed LLCs. This should be of concern to lenders because an allocation of assets by division may not violate the transfer and merger covenants in their loan agreements. Lenders should understand the potential impact on existing and future debt documents and take the steps outlined below to ensure they are adequately protected.

THE PLAN OF DIVISION

Section 18-217 of the DLLCA permits the division of an LLC into multiple new LLCs pursuant to a plan of division adopted in accordance with the terms of the statute (a "Plan"). A Plan must include (i) the allocation of assets, property, rights, debts and liabilities of the dividing LLC among itself and/or the new LLCs, (ii) the name of the surviving LLC (if the dividing LLC will survive the division) and the name of each new LLC, (iii) the name and address of a division contact that will retain custody of a copy of the Plan and (iv) any other matters that the dividing LLC determines to include. Upon adoption of the Plan, a certificate of division must be filed with the Delaware Secretary of State along with a certificate of formation for each new LLC. The certificate of division will include limited information about the transaction and will not provide any details about the underlying allocation of assets. The Plan itself is not required to be publicly filed or provided to creditors.

THE EFFECTS OF A DIVISION: LIABILITIES & SAFE HARBORS

Upon the effectiveness of a division, all assets and property of the dividing LLC will automatically be allocated to and vested in the applicable LLCs in accordance with the terms of the Plan. Each LLC resulting from the division is only liable for those debts, liabilities and duties of the dividing LLC as are allocated to it under the Plan and not for the aggregate liabilities of the related group. Debts and liabilities shall be joint and several obligations of all related LLCs only in the event that (i) the Plan does not provide for an allocation of such debts and liabilities or (ii) the allocation of assets and liabilities under the Plan is determined by a court of competent jurisdiction to constitute a fraudulent transfer.

Section 18-217(o) provides a limited safe harbor for written contracts, indentures or other agreements entered into prior to August 1, 2018 by LLCs that were formed prior to such date. To the extent a term in a written contract, indenture or other agreement entered into prior to August 1, 2018 contains a provision restricting transfers of assets, such restriction will be deemed to apply to any division as though it constituted a "transfer". For such agreements, lenders will be afforded the protection of customary covenants prohibiting transfers even if a division under Delaware law is not specifically mentioned. Unfortunately, the statute does not contain any similar language with respect to contracts entered into or LLCs formed after such date and so the implication is that a division of assets/liabilities under new Section 18-217 may not constitute a "transfer" under typical debt documents.

THE PATH FORWARD FOR LENDERS

Although credit agreements and indentures will typically include restrictions on mergers, transfers of assets and similar transactions, most existing covenants do not specifically address an allocation of assets/liabilities by division. In order to avoid potential pitfalls resulting from ambiguities inherent in existing debt covenants, lenders are advised to carefully review their debt documents and draft covenants with this type of division in mind.

Depending on the negotiating leverage of the parties in a given transaction, lenders should consider prohibiting newly formed LLCs from engaging in such divisions under the terms of their organizational documents. Section 18-217 states that a limited liability company agreement may provide that an LLC shall not have the power to effect such a division. This would afford the greatest level of protection to lenders by effectively voiding any purported transfer as being outside of the powers of the LLC.

Lenders should also ensure that covenants restricting asset sales, assignments, mergers, dividends and similar transfers specifically include LLC divisions. Lenders should confirm that any restrictions on investments in and transfers to unrestricted subsidiaries capture allocation through division. Customary "further assurances" covenants requiring newly formed subsidiaries to provide guaranties and/or collateral support should be updated to cover LLCs formed under such a division. Finally, lenders should review collateral release provisions to ensure that an automatic release of liens will not be inadvertently triggered upon an allocation of assets outside of the credit group.

To the extent a new LLC is allocated assets under a Plan which constitute collateral under a financing arrangement, lenders are advised to file the appropriate financing statements to perfect their security interests in such assets. Lenders can request the name and address of any new LLC from the relevant division contact who is required to serve for a period of six years and provide such information to any requesting creditor of the relevant LLC. Although Section 18-217 states that all liens upon any property of a dividing LLC shall be preserved unimpaired after an allocation pursuant to a Plan, the filing of such financing statements should mitigate any future issues with competing creditors of a new LLC who may not otherwise be aware of the occurrence of the division.

CONCLUSION

Section 18-217 affords Delaware LLCs additional flexibility in managing their assets by facilitating spinoffs and other dispositions. At the same time, it could create loopholes for collateral leakage under standard debt documents that were drafted without contemplating this new type of division. Lenders should update their financing documents to account for divisions under Delaware law. A few simple fixes to form documents will go a long way in protecting lenders against any unintended consequences of these statutory developments.

QUESTIONS

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