

Client Alert

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Shumaker, Loop & Kendrick, LLP

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A House Divided: New Risks to Lenders Under Delaware LLC Law

W. Kent Ihrig, Partner | kihrig@shumaker.com | 813.227.2354

Recent changes to the Delaware Limited Liability Act (the “Act”) will require modification to Lenders’ forms of loan documentation, at least as they relate to loans to Delaware LLCs. The Act was amended effective as of August 1, 2018 by adding a new Section 18-217 to the Delaware Code, which allows a limited liability company organized in Delaware (referred to as a “dividing company” under the Act) to divide into two or more limited liability companies (referred to as “resulting companies” under the Act). The dividing company can, but is not required to survive the division. If the dividing company survives the division it is referred to as a “surviving company”. Resulting companies and the surviving company, if any, are referred to as “division companies” under the Act.

In order to undertake a division, the dividing company must adopt a plan of division, which is not required to be publicly filed, setting forth how the dividing company will be divided, whether or not the dividing company will survive, any conversion or exchange of the limited liability interests of the dividing company for membership interests, securities or obligations of any division company or other assets, the allocation of assets, debts, liabilities and duties of the dividing company among the division companies, the name of each resulting company and, if the dividing company will survive, the name of the surviving company, the name and address of a contact whom must maintain custody of the plan of division and who will serve in such capacity for a period of six (6) years after the effective date of the division, and other matters that the dividing company determines to include. Creditors of the dividing company are entitled during such six (6) year period to obtain from the contact named in the plan of division within thirty (30) days of written request a copy of the plan of division and the

name and business address of the division company to which such creditor’s claim was allocated. Additionally, a certificate of division must be filed with the Delaware Secretary of State. Under the revisions to the Act, creditors of the dividing company are not required to consent to or approve any division.

Resulting companies are liable only for obligations allocated to them under the plan of division unless the same constitutes a fraudulent conveyance; although liens on the dividing company’s property continue unimpaired. Resulting companies are jointly and severally liable for (i) debts and liabilities that are not allocated under the plan of division and (ii) any allocation under the plan of division which constitutes a fraudulent conveyance as determined by a court of competent jurisdiction.

Delaware LLCs are relatively common as borrowers and/or guarantors in US loan transactions. Most loan documents prohibit certain fundamental changes to borrowers, guarantors or other loan parties, including mergers, consolidations and transfer of assets. However, these provisions do not contemplate, much less address, “divisions” as permitted under the Act as amended. The revisions to the Act do provide that any agreement entered into prior to August 1, 2018 which contains restrictions on mergers, consolidations or transfer of assets of an affected Delaware LLC will be deemed to apply to a division as if the division constituted a merger, consolidation or transfer of assets. For agreements, including loan documents, entered into as of or after August 1, 2018, however, such provisions do not have the same protective effect, are not sufficient to address the new division concept, and should thus be revised. Modifications to loan

document forms should include at a minimum adding division of a Delaware LLC as a matter restricted (if not prohibited) under the standard fundamental changes provisions and revising the security interest and “further assurance” provisions so as to provide that it is the intent of the parties that security interests continue in collateral which may be allocated to a resulting company and that the resulting company shall be required to take such actions as are necessary to continue and perfect such security interests. Additionally, lenders may also consider whether to require a borrower, guarantor or other loan party (especially if the same is intended to be a single purpose entity) to amend its limited liability company agreement so as to prohibit a division pursuant to new Section 18-217 as a condition of extending or continuing to extend financial accommodations.

If you would like more information or if we can provide assistance in advising as to modification of loan document forms or amendments to existing credit facilities, please contact a member of our Financial Services team.

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