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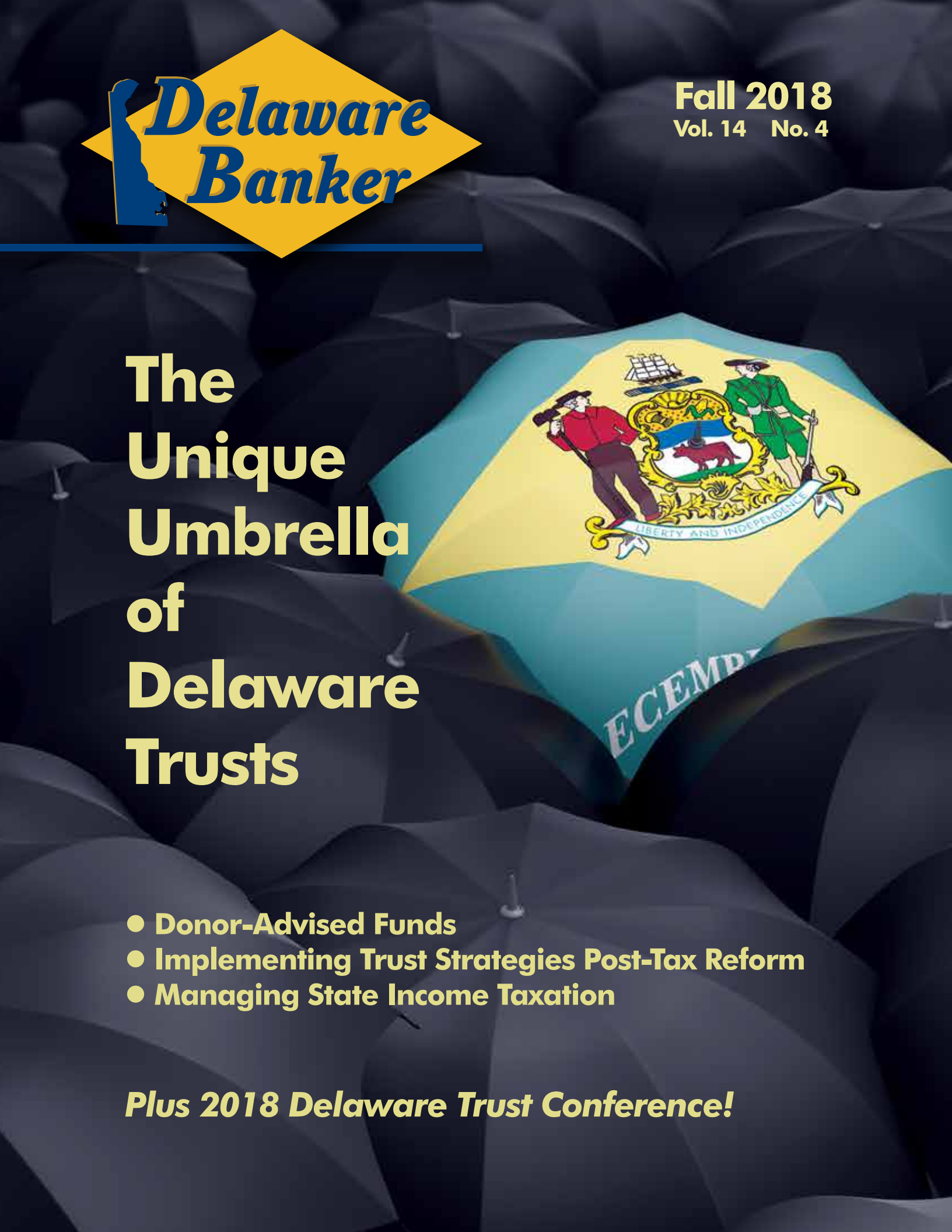

The Unique Umbrella of Delaware Trusts

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Lending Law Update

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New Delaware Limited Liability Company Divisions – Simple or Complicated for Lenders?

There has been a great amount of chatter among lenders lately regarding one of the recent changes to Delaware's Limited Liability Company Act (the "Act"). Effective August 1, 2018, an existing Delaware limited liability company ("E-LLC") may now "divide" itself into two or more Delaware LLCs by adopting a "plan of division," allocating debts and liabilities among the resulting LLCs. The E-LLC may or may not be one of the LLCs that survives the division; if it does the E-LLC does not dissolve or need to wind up its affairs (if the LLC is taxed as a corporation there are tax advantages from this). The Act provides that the division does not affect the validity of the E-LLC's obligations prior to the division; but those obligations are allocated to a resulting LLC (maybe not resembling the E-LLC that the bank intended to have as its customer). What is a bank to do?

Banks should check if existing covenants in loan or credit agreements prohibiting changes in the form or composition of a loan's LLC borrower and guarantors are already sufficient to cover divisions. If not, language similar to the following should be added: "Borrower [or Guarantor] may not enter into any plan of division, divide, establish a protected series, create a new registered series, or convert to another form of incorporated or unincorporated business or entity." This provision should result in the bank having leverage to declare a default if an E-LLC divides without bank approval or satisfying the bank's conditions for approval, such as assumption of loan obligations by the resulting LLCs and appropriate allocation of assets and liabilities. The lender may also want to take this one step further by requiring the borrower's (or guarantor's) LLC operating agreement to be amended to prohibit divisions (the Act provides for this ability to prohibit divisions in the LLC agreement).

These solutions appear simple and obvious. The complexity arises if the borrower or guarantor divides despite the prohibiting loan covenant, risking default and asking for forgiveness later. The plan of division of the E-LLC itself is not invalidated by any language in the loan documents. Loan repayment may be triggered, but what if the assets and the bank debt were allocated to different LLCs? Does the lender now need to pursue all the divisions? Is the transfer fraudulent if not made with the proper level of consideration? Lastly, what is the impact of the division for federal and state income tax purposes? The amendments to the Act are too recent to allow all the forgoing (and more) implications from being fully vetted or understood. Most of these implications arise at the peril of the borrower only if the default provisions in the loan documents are not solid and unambiguous. Stay tuned; the answers are yet to come.