

Client Alert

August 2018

Newly Passed Delaware Law Permits “Divisive Mergers” of Limited Liability Companies

What Happened: On July 23, 2018, the Delaware Limited Liability Company Act (the “Delaware LLC Act”) was amended to allow a Delaware limited liability company (“LLC”) to divide itself into two or more LLCs and allocate the assets, liabilities, rights, and duties of such original (“dividing”) LLC among the newly created (“division”) LLCs (the “Divisive Merger Amendment”). The Divisive Merger Amendment was effective August 1, 2018.

The Bottom Line: The adoption of a divisive merger statute in Delaware, already the most popular jurisdiction for legal entity formation, will provide LLC members additional flexibility in managing and disposing of the assets, liabilities, rights, and duties of the company. Because it may be used to circumvent an assignment or transfer restriction in a contract with a third party, parties entering into agreements with Delaware LLCs should be wary of the repercussions the Divisive Merger Amendment can have on restrictive covenants, including prohibitions on assignment, after August 1, 2018. However, for contracts entered into before August 1, 2018, a restriction on merger, consolidation, or the transfer of assets will be deemed to also restrict divisive mergers.

The Full Story

Newly enacted Section 18-217 of the Delaware LLC Act allows an existing Delaware LLC to be divided into two or more Delaware LLCs, and to allocate the assets, liabilities, rights, and duties of the dividing LLC among the division LLCs. Section 18-217 does not require the dividing LLC to wind up its affairs. Rather, an LLC availing itself of Section 18-217 has two options: (1) divide into two or more newly formed LLCs that would be the surviving entities or (2) survive the division merger and retain certain assets, liabilities, rights, and duties, and otherwise allocate other assets, liabilities, rights, and duties among one or more newly formed LLCs.

In order to effect a divisive merger, the dividing LLC must first adopt a plan of division, which must set forth (1) the terms and conditions of the division, including the conversion or exchange of the LLC interests of the dividing LLC into or for LLC interests or other securities of the division LLCs and the allocation of assets, properties, rights, series, debts, liabilities, and duties of the dividing LLC among the division LLCs; (2) the name of each resulting LLC (including the name of the dividing LLC if it will survive the division merger); (3) the name and business address of a division contact which shall have custody of a copy of the plan of division; and (4) any other matters that the dividing LLC determines to include. The plan of division may effect amendments to the LLC company agreement of the dividing LLC (if it will be surviving the division merger) or the adoption of a totally new LLC company agreement of the dividing LLC, and must effect the adoption of a new LLC company agreement for each newly created LLC.

It is not necessary for a plan of division to list each individual asset, property, right, series, debt, liability, or duty of the dividing LLC to be allocated to a division LLC so long as the assets, property, rights, series, debts, liabilities, or duties so allocated are reasonably identified by any method where the identity of such assets, property, rights, series, debts, liabilities, or duties is objectively determinable. It is important to note that debts and liabilities of the dividing LLC that are not allocated by the plan of division shall be deemed the joint and several debts and liabilities of all of the division LLCs. For this reason, specificity with respect to the assignment or retention of debts and liabilities will be important.

The plan of division may be adopted as specified in the dividing LLC's company agreement. In the absence of specification in the LLC company agreement, as will be the case initially for nearly all entities due to the law's very recent enactment, Section 18-217 provides that a plan of division must be adopted in the same manner as a plan of merger, if the manner for adopting a plan of merger is specified in the LLC company agreement. In the absence of a specific provision in the LLC company agreement with respect to adoption of plans of mergers, a plan of division must be adopted by 50% or more of the members of the dividing LLC.

After adoption of the plan of division, a certificate of division must be filed, which must include certain information as required by Section 18-217. The certificate of division and certificates of formation for the newly created LLCs must be filed simultaneously in the office of the Delaware Secretary of State. While Section 18-217 permits certificates of division to have a future effective date, the certificate of division and the creation of the newly formed LLCs via effectiveness of their certificates of formation must all have the same effective date or time.

After the divisive merger is effective, the rights, privileges, powers, and interests in property of the dividing LLC that have been allocated to a division LLC, as well as the debts, liabilities, and duties of the dividing LLC that have been allocated to such division LLC pursuant to a plan of division, shall remain vested in each such division LLC and shall not be deemed, as a result of the division, to have been assigned or transferred to such division LLC for any purpose of the laws of the State of Delaware. This means that a divisive merger may be used to circumvent an assignment or transfer restriction in a contract with a third party if such restriction is not broad enough to also capture assignments or transfers by operation of law such as conversions and mergers (including divisive mergers).

Section 18-217 will not have retroactive effect and as such cannot be used as a way to circumvent contractual obligations under agreements with third parties existing prior to August 1, 2018, so long as such obligations restricted mergers, consolidations, or the transfer of assets. However, lenders and counterparties should consider specifically addressing divisive mergers in future contracts with Delaware LLCs. Section 18-217 provides that its terms shall apply to all LLCs formed before or after August 1, 2018, but if a dividing LLC is a party to any written contract, indenture, or other agreement entered into prior to August 1, 2018, that, by its terms, restricts, conditions, or prohibits the consummation of a merger or consolidation by the dividing LLC with or into another party, or the transfer of assets by the dividing LLC to another party, then such restriction, condition, or prohibition shall be deemed to apply to a division as if it were a merger, consolidation, or transfer of assets, as applicable. While it is too early to tell how Delaware's courts will interpret this provision, the implication of expressly making it applicable to "any written contract, indenture or other agreement entered into prior to August 1, 2018" is that a restriction, condition, or prohibition with respect to mergers, consolidations, or transfers of assets in agreements entered into after August 1, 2018, will not automatically be deemed to encompass divisive mergers unless expressly addressed in such restriction, condition, or prohibition.

Finally, it may be possible to use Section 18-217 to allocate permits and licenses for businesses that, in the course of their business, may want to divide their operations among various entities but may be hesitant to do so because the permits or licenses for certain aspects of their operations are not assignable or transferable except by operation of law.

Authors

Stefano D'Aniello
sdaniello@HuntonAK.com

Uriel A. Mendieta
mendietau@HuntonAK.com

Steven M. Haas
shaas@HuntonAK.com

Rail Seoane
rseoane@HuntonAK.com