The Impact on Real Estate Lenders of Delaware Limited Liability Company Act Changes

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The State of Delaware has built upon its preeminence in American corporate law by positioning Delaware limited liability companies ("Delaware LLCs") as the entity of choice for ownership of real estate, especially when serving as special purpose entities required in structured finance transactions. One reason it has maintained this position is the enactment of annual amendments to the Delaware Limited Liability Company Act, Del. Code Ann. tit. 6, § 18-101 et seq. (the "Act"), to allow Delaware LLCs to meet the ever-developing needs of the marketplace.

The 2018 annual revisions to the Act have engendered an atypical amount of conversation among real estate lenders over the effect of the revisions. There are two changes that are very relevant to real-property-owning entities. First, effective August 1, 2018, an existing Delaware limited liability company (an "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. Id. § 18-217. Second, beginning later this year, Delaware LLCs will be able to form registered series. Id. § 18-215 (effective Aug. 1, 2019). The first change, intended to increase Delaware LLC business planning flexibility by permitting transfers of assets and liabilities without triggering other consequences of assignment, dissolution, or termination under state law, was generally unexpected by national lenders and initially created a sense of trepidation, or in some instances alarm, in that community. Id. § 18-217(l)(8). The second change may make a series limited liability company, long shunned by lenders, palatable in real estate circles at last.

Division of Existing Delaware LLCs

How It Works

To divide an E-LLC (referred to in the Act as the "dividing company"), it must adopt a plan of division. Del. Code Ann. tit. 6, § 18-217(g). The E-LLC may or may not be one of the "resulting company" LLCs that survives the division; if it does, the E-LLC is the "surviving company" and does not dissolve or need to wind up its affairs (if the LLC is taxed as a corporation there are tax advantages to this). The new LLC or LLCs created in the division are "resulting companies" and, together with the surviving company (if any), are referred to in the Act as "division companies." Id. § 18-217(a).

Unless its operating agreement provides otherwise, the plan of division must be approved by a majority in interest of the E-LLC's members. Id. § 18-217(c). The plan must set forth how membership interests in the dividing company will be dealt with (cashed out, exchanged for other interests, or left intact), how the assets and liabilities of the dividing company will be allocated among the division companies, the name of the surviving company (if any) and the resulting companies, and the name and address of a "division contact." Id. § 18-217(g). This contact is intended to provide, to any requesting creditor of the dividing company, the name and address of the division company to which the creditor's claim was allocated under the plan of division. Id.

The division is effectuated by filing with the Delaware Secretary of State not the plan itself, but instead a certificate of division that only needs to state the name of the dividing company, whether the dividing company is a surviving company, the name of each division company, and the name and address of the division contact. Id. § 18-217(h). A certificate of formation for each resulting company is filed with the Secretary of State at the same time. Id.

The allocation of assets per the plan does not constitute a transfer or a distribution for purposes of Delaware law. Id. § 18-217(l)(8), (m). Also, the division does not constitute a dissolution of the dividing company even if it is not a surviving company. Id. § 18-217(d). Instead, when the dividing company is not a surviving company, its existence will merely cease upon the division. Id. § 18-217(l)(1).

Statutory Comfort for Lenders

The trepidation of lenders arises from the statutory power of allocation. The new statute does reflect some sensitivity to debtor concerns by the drafting committee of the Delaware State Bar Association responsible for Act amendments. The power of division applies to all existing Delaware LLCs formed before August 1, 2018; except that if the existing company is party to any written agreement entered into before August 1, 2018, that restricts, conditions, or prohibits a merger or consolidation, then such restriction, condition, or prohibition will apply to a division as if it were a merger. 6 Del. C. § 18-217(o). After August 1, 2018, the operating agreement of any newly formed Delaware LLC may prevent (or the operating agreement of an older Delaware LLC may be amended to prevent) divisions. Id. § 18-217(c).

The Act provides that the division does not affect the validity of the E-LLC's obligations before the division, though those obligations are allocated to a resulting LLC (maybe not resembling the E-LLC that the lender intended to have as its customer). Id. § 18-217(b).

Another protection for lenders is the statutory provision that states "[d]ebts and liabilities of the dividing company that are not allocated by the plan of division shall be the joint and several debts and liabilities of all the division companies." Id. § 18-217(l)(6).

Finally, the Act provides that if a court determines that an allocation in a division constitutes a fraudulent transfer, then each division company is jointly and severally liable on account of the fraudulent transfer, notwithstanding the plan's stated allocations. Id. § 18-217(l)(5).

How to Deal with Lender Concerns

With respect to existing real estate loans and loan document forms, a review by the lender's counsel is prudent. The first thing to determine is whether the existing covenants in the loan or credit agreement prohibit changes in the form or composition of the LLC borrower and guarantors. Document language may already be sufficient to cover divisions, but, if not, it may be advisable to amend the loan documents to add language similar to the following: "Borrower [or guarantors if applicable] 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." Certainly the lender needs leverage to declare a default if an E-LLC divides without lender approval or satisfaction of the lender's conditions precedent 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 so that it prohibits divisions (as discussed above, the Act provides for this ability to prohibit divisions in the LLC agreement). See Del. Code Ann. tit. 6, § 18-217(c). Some have suggested adding lengthy clauses to loan documents that specify what any plans of division must provide in terms of allocations, resulting companies, loan assumptions, and more. In the view of the authors, however, these provisions are unnecessary and would not invalidate, affect, or change the legal effect of the actual division plan itself.

Some interesting questions arise if the borrower or guarantor risks default by dividing in violation of covenants in the loan documents, in effect asking for forgiveness later. The obvious lender fear is that the assets and the bank debt are allocated to different LLCs. As noted in the Act itself, such an allocation may constitute a fraudulent transfer that could be challenged under state or federal law if not made with the proper level of consideration. Also, lenders should note that the mortgage lien on the real estate itself will still be valid despite the allocation. In fact, the Act specifically provides "all liens upon any property of the dividing company shall be preserved unimpaired." Id. § 18-217(l)(4).

Will lawyers start adding assumptions that no division has occurred to their legal opinions delivered at loan closings? This should not be necessary, given that most opinions already state the qualification that they are based on the review of a specific list of organizational documents and amendments, and they assume no other amendments exist (which includes by implication a certificate of division). Documentation for divisions that occur on or before the date of the opinion must be reviewed by the opining lawyer in the same manner as other organizational documents; divisions that occur later are not relevant, as legal opinions are given with respect to circumstances only as of the date of the opinion.

To the extent that a division of a real-estate owning entity occurs, are there title insurance coverage implications? The division should not affect or void a loan title insurance policy, because the policy insures matters only as of the date of the policy. With respect to an owner's policy, the issue is whether the policy can be enforced by the surviving company or is effectively rendered void by the division. Under the form ALTA Owner's Policy of Title Insurance (revised June 17, 2006), the definition of "insured" does include "successors to an insured by dissolution, merger, consolidation, distribution, or reorganization." It appears that "distribution" may be broad enough to cover the division. Underwriting the issuance of a policy will need to include obtaining a long-form certificate of good standing from the Delaware Secretary of State, which lists all filings made by the LLC over time, including a certificate of

division if one exists. However, this should already be standard practice, as it is also needed pick up mergers, consolidations, name changes, and so forth of the property owner. The title agent will also need to check with the division contact to ascertain to which resulting company the real estate was allocated.

Divisions of Delaware LLCs may trigger state and local transfer taxes, depending on the breadth and wording of the applicable transfer tax statutes and regulations in the jurisdictions where the real estate owned by the dividing Delaware LLC is located. Although it does not affect lenders directly, this issue should always be looked at closely if a division is contemplated.

Registered Series of Delaware LLCs

Problems with Applying Uniform Commercial Code Article 9 Provisions to Series LLCs

For many years, the Act has permitted operating agreements of Delaware LLCs to provide for the establishment of one or more designated series of members, managers, limited liability company interests or, most importantly, assets. Del. Code Ann. tit. 6, § 18-215(a). Every series created pursuant to the operating agreement before the amendments effective August 2019 is not established by any sort of filing with the Delaware Secretary of State, but, to create a series, the Delaware LLCs certificate of formation must contain a general notice of the limitation on liabilities of a series. Id. § 18-215(b). Despite such notice, no series has to be established, and there is no requirement that any specific series of the limited liability company be referenced in the notice. The primary reason for establishing a series is that, at least to the extent governed by Delaware law, an internal shield can be created so that the debts, obligations, and other liabilities of a given series can be stated to be enforceable only against the assets of such series and not against the assets of the limited liability company generally, or any other series of such Delaware LLC. Id. § 18-215(b). Yet, as the majority of United States jurisdictions do not have similar provisions with respect to series LLCs, given the interplay of conflict of laws rules to various transactions the internal shield may not always be recognized. See Norman M. Powell, *Secured Lending to Series of LLCs: Beware What You Do Not (and Cannot) Know*, 46 UCC L.J. 95, 98 (2015).

Real estate lenders have long been queasy about lending to a series, as opposed to the entire series LLC, for several reasons. One of those reasons has been the lack of assurance that the lender's security interest in assets of only a particular series has been properly perfected pursuant to the secured transactions provisions of the UCC.

Under the UCC, a limited liability company itself is a registered organization. U.C.C. § 9-102(a)(71). As to assets in which the lender's security interest is perfected by filing, the financing statement is to be filed in the financing statement records where the debtor is located in order to perfect the security interest in such assets. A registered organization is located in the jurisdiction where the LLC's certificate of formation is filed. Id. § 9-307(e).

In contrast, until August 1, 2019 a series itself, not being a registered organization, is to be treated under the UCC either as an individual (not defined in the UCC) or as a non-registered organization ("any other legal or commercial entity"); but the Act does not state that a series is an entity. Id. § 1-201(b)(25).

Therefore, for lenders it is unclear not only where to file financing statements to perfect a security interest in a series but also whether a series even falls within the scope of UCC Article 9. Norman M. Powell, *Dissonance in the Attempt to Harmonize LLC Series and Article 9,* 46 UCC L.J. 279, 283 (2015).

The Act's UCC Solution

Under the Act's amendments effective August 1, 2019, regardless of whether a Delaware LLC has a protected series with internal shields, a series may be established as a registered organization under UCC Article 9 by filing a certificate of registered series with the Delaware Secretary of State. Del. Code Ann. tit. 6, § 18-218(a). The certificate of registered series must set forth the name of the limited liability company and the name of the registered series. Id. § 18-218(d). It is clear in the statute that the registered series may establish itself as an internally shielded protected series; the records for the series must account for the assets associated with such series separately from other assets of the Delaware LLC or other series. Id. § 18-218(c).

Conclusion

Given the preferences of lenders and real estate developers to have real-estate-owning LLCs formed in Delaware, the 2018 amendments to the Act are relevant to lenders financing real estate throughout the country. Has the Delaware drafting committee gone too far this time with the annual amendments? At this juncture, it appears not. The new division provisions, while certainly a new concept for lenders to deal with, can ultimately be handled easily by fairly minor tweaks to loan documentation. Moreover, the new provisions for registered series LLCs in Delaware may help lenders overcome the major UCC hurdle faced by lending to only a series of a Delaware LLC. n