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Insights

Something New for Lenders to Think About: Divisions

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The Delaware legislature has enacted a change to Delaware LLC law that enables a single LLC to divide into two or more LLCs. A similar procedure is available for Delaware limited partnerships, but this article addresses only LLCs.

The "division" concept is the converse of a merger. Currently, of course, it is possible to do a spin-off by transferring assets to one or more new business entities. However, Delaware law states that a division does not constitute a "transfer" under Delaware law. In that respect, it is similar to a merger, but it is not clear at this point whether a division will be treated as a transfer under the law of other states.

The fact that a division can potentially be done without a transfer might incentivize some companies to try a division. For example, a division might provide transfer tax savings or avoid transfer restrictions in loan documents or other agreements that would otherwise prohibit a spin-off.

The division concept presents possible pitfalls for lenders. The procedure for effecting a division requires a plan of division that identifies the entities involved and the assets and liabilities each entity will be allocated. The major restrictions with respect to the allocation are (1) each of the entities will be jointly and severally liable for any unallocated liabilities, and (2) if the division constitutes a fraudulent transfer under applicable law, then each of the entities will be jointly and severally liable for that avoidable transfer, although the validity of the division is not otherwise affected. While that result offers some protection for lenders, it is not nearly sufficient for most lenders.

As a result, lenders may want to augment those protections either by requiring the borrower to amend its organizational documents to prohibit a division, or by providing in its loan documents that a division by the borrower constitutes a default. While the latter approach does not prevent the borrower from dividing, it may at least give the lender grounds for calling the loan, which might motivate the borrower to seek the lender's consent in advance of a division.

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Currently, a “division” can be done only with Delaware entities. Depending on how popular the division concept becomes, however, Delaware or other states may at some point expand the division concept beyond its current limits. For a lender, now is a good time to begin thinking about divisions, and perhaps to revise form documents to deal with a division.

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