

Changes to the Delaware Limited Liability Company Act Affecting Commercial Real Estate Lending

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On July 23, 2018, Delaware Governor John Carney signed into law Senate Bill No. 183, which amends the Delaware Limited Liability Company Act (the “DLLCA”). The legislation addresses a number of aspects of Delaware limited liability company (a “Delaware LLC”); however, the amendments most affecting commercial real estate lending are the creation of a new type of Delaware series limited liability companies known as a “registered series” and the establishment of a process for dividing a Delaware LLC into multiple Delaware LLCs.

Delaware Registered Series LLCs

The DLLCA¹ was amended in 1996 to provide for the creation of an identified series of properties or operations, each having its own members, its own business purpose or investment objective, and its own powers and duties. Significantly, a Delaware series limited liability company (a “Delaware series LLC”) may have many of the characteristics of a separate limited liability company, and the debts, liabilities, obligations, and expenses incurred or existing with respect to one series

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¹ A series limited partnership or a series statutory trust may also be formed under the Delaware Revised Limited Partnership Act and the Delaware Statutory Trust Act, respectively. Series limited liability companies are also authorized under the laws of other states, but this article does not address those laws.

can only be enforced against the assets of that series and not against all the assets of the limited liability company or of any other series.² To qualify as a Delaware series LLC under the DLLCA, certain statutory conditions must be met. Among other things, a

Delaware series LLC is created by providing in the limited liability company agreement of the Delaware LLC for the creation of one or more series, and for the maintenance of separate and distinct records for each series and its assets with accounting treated separately from other assets of the limited liability company or other series, and by providing in the certificate of formation of the Delaware LLC a notice of this limitation of liability.

The series is not a separate and independent limited liability company. It is the limited liability company itself that is the separate, independent legal entity under Delaware law. On the other hand, because each series may have different members, managers, assets, and liabilities, and each series can have a specific business or investment objective, management and similar issues can be implemented differently for each series. In addition, the membership of a member can be with respect to each series and not the limited liability company generally, so that withdrawal from membership in one series does not necessarily affect membership in any other series.

² 6 Del. C. §18-215(a)-(b).

Subsequent amendments to the DLLCA clarified the manner in which assets may be accounted for and provided that in addition to series of members, a Delaware LLC may also have separate series of assets. Amendments also confirmed the broad purposes and powers granted to series, including that, unless otherwise provided in the limited liability agreement, a series will have the power, in its own name, to contract, hold title to assets (including real, personal, and intangible property), grant liens and security interests, and sue and be sued.

Accordingly, under Delaware law each series of a Delaware series LLC has an independent existence with respect to its liabilities and the exposure of its assets to third-party claims, and each series is able to hold property and perform functions as if it were an independent, single-asset limited liability company. Commentators have argued, however, that in the absence of an established body of case law on series limited liability companies, there are many questions, and therefore risks, that argue against its use. The most significant of these questions for real estate transactions are the enforcement of the limitation of liability as between series and treatment of the series limited liability company in bankruptcy.³

For example, as only a minority of states (plus D.C. and Puerto Rico) have enacted series entities, a court

³ See, generally, B. Borden and M. Vattainda, “Series LLC in Real Estate Transactions,” *Real Property Trust and Estate Law Journal*, 255 (Vol. 46 No. 2, Fall 2011).

outside Delaware, especially one in a jurisdiction that does not provide for series entities, might not honor the limitation of liability provisions of each series in the limited liability company and could “pierce the veil” between the series. This may be particularly true in the area of environmental liabilities.⁴ It is important to keep in mind that, while Delaware law should govern the internal affairs of the Delaware series LLC, another forum state could very well view third-party claims as governed by the laws of the forum state or some other state.⁵ Likewise, there is a question whether other states will impose state taxes on the gross receipts of a limited liability company on the limited liability company itself rather than on each series, thereby frustrating any benefits of using a series limited liability company in certain states to avoid multiple taxation resulting from the use of a separate limited liability company for each project.⁶

Importantly, how will courts handle the interrelationship between the Bankruptcy Code and Delaware corporate and limited liability company laws. Arguments have been raised that a series, which is not itself a legal entity under Delaware law, cannot file a bankruptcy petition on its own. Moreover, would a bankruptcy court honor the separateness of the series? For example, would the court honor the claims asserted by a secured lender with a nonrecourse loan on one series that the lender be allowed to treat its claim as having recourse against the

debtor under the Bankruptcy Code?⁷ Other commentators have questioned whether the use of a series would qualify for the separateness requirements of a special purpose entity for the rating agencies.

Another issue in using a series limited liability company is whether title insurance can be issued to insure a series as the owner of the insured property. Although under the DLLCA the series may hold property “as if” it were an independent legal entity, it is not a legal entity independent of the series limited liability company.⁸ While the DLLCA permits the series to hold title to assets, those assets appear to be limited to “specified property...of the limited liability company...”⁹ Therefore, under a title insurance company’s underwriting standards, it may question whether that title may be insured.¹⁰ It is also not yet clear whether the recently enacted status of a “registered series” discussed below will resolve this issue for real estate titles.

In addition to these more general issues with the use of a Delaware series LLC in commercial real estate financing, Delaware law until now failed to address some very practical aspects that are important to commercial financing transactions—in particular, where one files a financing statement against a

series debtor.¹¹ Certainly, a financing statement is to be filed in the name of the debtor,¹² but who is the debtor under Article 9 of the Delaware UCC. The DLLCA states that the assets of a series may be held in the name of the series, the limited liability company, a nominee or “otherwise.”¹³ But the Delaware UCC defines “debtor” as, among other things, “a person having an interest, other than a security interest or other lien, in the collateral, whether or not the person is an obligor...”¹⁴ A series may not be a “person” for purposes of the Delaware UCC and, therefore, perhaps cannot be a debtor.¹⁵ Even if the series can be a debtor, where would the financing statement be filed? While a series can hold assets in its name, it is not an independent legal entity under the DLLCA; it is not a registered organization (the limited liability company is, but the series is not), and therefore the place for filing will be governed by the general rules (e.g., debtor’s place of business).¹⁶

In addition, because the series is not an independent legal entity, the Delaware Secretary of State was not able to issue a good standing certificate for the series under the prior law.

The new legislation addresses both of these practical challenges. The legislation creates a subspecies of a Delaware series LLC known as a “registered series.” As discussed above, under prior law, it is not clear whether a series is a person separate from the limited liability company itself and whether the

⁴ J.C. Murray, “A Real Estate Practitioner’s Guide to Delaware Series LLCs (with forms)” *Prac. Real Estate Law*, 23 (21 No. 6, 2005).

⁵ See *Alphonse v. Arch Bay Holdings, L.L.C.*, 2013 WL 6490229 (5th Cir., Dec. 11, 2013); *Butler v. Adoption Media, LLC*, 2005 WL 207484 (N.D. Cal. 2005).

⁶ For tax issues generally, see M. McLoughlin and B. Ely, “The Series LLC - Raises Serious State Tax Questions but Few Answers are yet Available,” *J. of Multi-State Taxation and Incentives* (Jan. 2007).

⁷ See, for example, 11 USC §101 (41) for the definition of a “person” who can commence a case or against whom a case can be commenced. See, M. Harner, et al., “Series LLCs: What Happens When One Series Fails? Key Considerations and Issues,” *Bus. L. Today* Feb. 2013 at 1; A. Hiller, “A Series? What’s That? Understanding Delaware Series Laws and its Treatment in Title 11,” *ABI Journal*, 54 (July 2002).

⁸ For example, the Delaware Secretary of State cannot issue a good standing certificate for a series, but only for the series limited liability company, except if the series elects to be a “registered series.”

⁹ 6 Del. C. §18-215(a). See *G & G Management, LLC v. Young Bros. and Co., Inc.*, 2007 WL 1702872 (D. Me. June 11, 2007). Note that a series may be treated as a separate legal entity for federal income tax purposes. Tax Rul. 200803004, P.L.R. 2008 WL 163064 (January 18, 2008).

¹⁰ For example, see First American Title Insurance Group Underwriting Communication DE-3.8.2016 (February 8, 2016).

¹¹ N. M. Powell, “Series LLCs, the UCC, and the Bankruptcy Code—A Series of Unfortunate Events,” *Uniform Commercial Code Law Journal*, Vol. 41, No. 2, p. 103.

¹² See Section XII. C.

¹³ 6 Del. C. §18-215(b).

¹⁴ 6 Del. C. §1-102 (a)(28).

¹⁵ 6 Del. C. §1-201(b)(27).

¹⁶ 6 Del. C. §9-307.

limited liability company or the series is the “debtor,”¹⁷ and thus, which of the limited liability company or the series would grant the security interest.¹⁸ However, the new legislation creates the ability of a Delaware limited liability company to elect to file as a so-called “registered series” through a separate filing with the Secretary of State.¹⁹ Such a “registered series” is a “registered organization” under the Delaware UCC²⁰ and, as with any other registered organization, the place for filing for perfection will be governed by those same rules, as discussed below. Moreover, a registered series will qualify as a registered organization under the Delaware Uniform Commercial Code, thereby clarifying that the Delaware Secretary of State is the place to file a financing statement for a registered series as debtor. Finally, the Delaware Secretary of State will, upon the August 1, 2019, effective date, be able to issue certificates of good standing with respect to a registered series.²¹

To form a registered series, the certificate of formation of the Delaware series LLC must contain a notice of the limitation of liabilities of the registered series, and a separate certificate of registered series must be filed with the Delaware Secretary of State.²²

Although most of the new amendments to the DLLCA were effective August 1, 2018, the provisions with respect to the registered series will be effective August 1, 2019, in order to provide the Delaware Secretary of

State’s office with the time necessary to prepare for the new filing process.

Governor Carney also signed into law Senate Bill No. 196, which amends the Delaware Uniform Commercial Code to include in the definition of “registered organization” a series limited liability company, whether formed in Delaware or in another state where series are authorized, and thereby authorizing the filing of a financing statement for a Delaware registered series with the Delaware Secretary of State. This legislation will also be effective August 1, 2019, to be consistent with the effective date of the new procedures for the filing of a registered series.

Division of a Limited Liability Company

The new amendments to the DLLCA also adopted the concept of a division, which functions effectively like a reverse merger. Under the amended act, a Delaware LLC can now divide itself into two or more Delaware LLCs.²³ The original dividing Delaware LLC can continue its existence or can terminate as part of the division depending on what is provided in the plan of division. A dividing Delaware LLC must adopt a plan of division by stating the terms and conditions of the division, including the allocation of assets, property, rights, liabilities, and duties of such dividing Delaware LLC among the division Delaware LLCs,²⁴ the name of each resulting Delaware LLC, and, if the original dividing Delaware LLC will survive the division, the name of the surviving Delaware LLC.²⁵ The surviving Delaware LLC or resulting Delaware LLC, as applicable, must then file a certificate of division (but

not the plan itself) and a certificate of formation for each resulting Delaware LLC with the Delaware Secretary of State.²⁶

Following a division, the assets of the dividing Delaware LLC will automatically be allocated to and vested in the division Delaware LLCs according to the plan of division, and each division Delaware LLC will be liable for the debts, liabilities, and duties of the original dividing Delaware LLC, as those have been allocated to it pursuant to the plan of division.²⁷ No other division Delaware LLC will be liable for those obligations except if the plan of division constitutes a fraudulent transfer under applicable law.²⁸ If any allocation of assets or liabilities is determined to constitute a fraudulent transfer, each division Delaware LLC will be jointly and severally liable on account of such fraudulent transfer.²⁹ Debts and liabilities of the original dividing Delaware LLC that are not allocated by the plan of division will be the joint and several debts and liabilities of all division Delaware LLCs.³⁰

One of the questions that has arisen in consideration of these new provisions of the DLLCA has been the effect of a division on anti-transfer covenants in loan documents or other contracts. Although a division is not a transfer under Delaware law³¹ and therefore would possibly not trigger an

¹⁷ 6 Del. C. §9-102(a)(28).

¹⁸ 6 Del. C. §9-203(a)(3).

¹⁹ 6 Del. C. §18-103(a).

²⁰ 6 Del. C. §9-102 (a)(71).

²¹ The Delaware Secretary of State will be able to issue certificates of good standing with respect to a registered series but not to a series that has not filed as a registered series.

²² 6 Del. C. §18-218(d).

²³ 6 Del. C. §18-217(b).

²⁴ References to “division Delaware LLCs” mean (i) the original dividing Delaware LLC effecting a division if that Delaware LLC survives the division and (ii) each resulting Delaware LLC formed as a consequence of the division.

²⁵ 6 Del. C. §18-217(g).

²⁶ 6 Del. C. §18-217(h).

²⁷ 6 Del. C. §18-217(l)(8).

²⁸ 6 Del. C. §18-217(l)(4).

²⁹ 6 Del. C. §18-217(l)(5).

³⁰ 6 Del. C. §18-217(l)(6).

³¹ 6 Del. C. §18-217(l)(8) (“The rights, privileges, powers and interests in property of the dividing company that have been allocated to a division company, as well as the debts, liabilities and duties of the dividing company that have been allocated to such division company pursuant to a plan of division, shall remain vested in each such division company and shall not be deemed, as a result of the division, to have been assigned or transferred to such division company for any purpose of the laws of the State of Delaware.”)

anti-transfer covenant, the amendments establish certain protections for lenders. First, as discussed above, a division that is a fraudulent transfer will not effect any change of liabilities but will make the division Delaware LLCs jointly and severally liable for those obligations.³² Second, in order not to affect existing contractual arrangements, the amendments to the DLLCA establishing the division concept do not affect the terms of any written contract, indenture, or other agreement that restrict, condition, or prohibit a Delaware LLC from consummating a merger or consolidation or transferring assets, and those terms will apply with equal force to a division if the dividing Delaware LLC was formed prior to August 1, 2018, and the dividing Delaware LLC entered into such written contract, indenture, or other agreement prior to August 1, 2018.³³ Third, the new legislation permits a Delaware limited liability agreement to provide that a Delaware LLC does not have the power to effect a division, and such a provision could be enforced by a lender just as with other separateness covenants that a lender requires to be included in the limited liability company agreement of the Delaware LLC.³⁴ Also, the implications for anti-transfer covenants may be more of an issue for collateral other than real property. As the allocation of assets by division is not a transfer under Delaware state law, it may be that for real property assets, proper titling will still require a deed, thereby triggering anti-transfer covenants; however, given the lack of certainty as to whether a division would be subject to a typical anti-transfer covenant entered into after August 1, 2018, lenders are considering how best to modify their loan documents to address this situation. Moreover, because the division process

could be considered substantially equivalent to the creation of new subsidiaries of the borrower, lenders are reviewing the forms of financial and related covenants to see if changes are needed to draw possible divisions within those covenants regarding subsidiaries.

Similar legislation has existed for some time in Texas, Arizona, and Pennsylvania. The key difference between the Delaware law and that of these other jurisdictions is that the latter generally allows for the division into different entities and even different jurisdictions (e.g., division of a Texas limited liability company into an Arizona limited partnership and a Texas corporation). The more narrowly crafted legislation in Delaware, therefore, might be seen as giving further comfort to lenders in that the Delaware Court of Chancery will retain jurisdiction over the new entities created by the division of the Delaware LLC.

Conclusion

The recent amendments to the DLLCA have clear implications for commercial real estate lending, creating both improvements and challenges. A Delaware series LLC may now be more suitable for use in commercial real estate, but a number of challenges still remain to any widespread use, and a Delaware series LLC should be used with caution. In addition, a Delaware LLC now has the ability to deal with assets and liabilities by way of division, which may present challenges to lenders to ensure that their collateral is not dispersed in ways the lender cannot control. All in all, given the prevalence of using Delaware LLCs as borrowers or mortgagors in commercial real estate transactions outside Delaware, these are important changes to the commercial real estate finance landscape.

³² 6 Del. C. §18-217(l)(5).

³³ 6 Del. C. §18-217(o).

³⁴ 6 Del. C. §18-217(k).