How Delaware Refreshed Its LLC Act And General Corp. Law

By **Allison Land and Anne Connolly** (August 6, 2018, 12:45 PM EDT)

Allison Land

Anne Connolly

On July 24, 2018, Delaware Gov. John Carney signed into law amendments to the Delaware Limited Liability Company Act and the Delaware General Corporation Law, which are intended to keep these laws current and maintain their national preeminence. All of the amendments discussed herein became effective Aug. 1, 2018, except for the amendments relating to registered series, which will become effective Aug. 1, 2019.

This year's amendments provide for (1) the division of an LLC into two or more separate LLCs, (2) the formation of registered series of LLCs and statutory public benefit LLCs, (3) the use of blockchain technology for maintenance of LLC and LP records and for electronic transmissions, among other things, (4) the application of the "market out" exception to appraisal rights for Section 251(h) short-form mergers, and (5) certain changes to the procedures for ratification of defective corporate acts.

Division of LLCs

The amendments enable a single LLC to divide into two or more newly formed LLCs with the dividing company either continuing or terminating its existence, as the case may be.

A division may be utilized to facilitate, among other things, a spinoff, the sale of one or more lines of business, or the sale of assets, rights and properties, along with related liabilities, thereby eliminating the need to transfer assets and liabilities, or assign contracts or licenses, to newly formed LLCs. Rather, upon effectiveness of a division, the dividing company's assets and liabilities are "allocated" to, and vested in, the resulting LLCs, as specified in a plan of division, without the need for any further action by any party. The division of an LLC could also be utilized, for example, to facilitate the sale of several lines of business to separate buyers simultaneously, and the equity interests in the resulting LLCs would be issued solely to the buyers of such lines of business.

Interests in the dividing LLC may remain outstanding (if the dividing LLC survives) or be exchanged for, or converted into, cash, property or interests in one or more of the resulting LLCs or in any other business entity, in each case, as set forth in the plan of division.

Plan of Division

The plan of division need not specifically identify each asset and liability to be allocated to a resulting LLC, so long as each asset and liability of the dividing company is reasonably identified and attributable to a resulting LLC, by any method where the identity is objectively determinable. While a certificate of division is required to be filed with the Delaware secretary of state in order to effectuate the division, the underlying plan of division setting forth the specific terms, conditions and allocation between the resulting LLCs is not required to be filed with the Delaware secretary of state or otherwise be publicly available.

Protective Provisions

Existing creditors are protected by a provision that makes each division company jointly and severally liable for any liabilities that are not allocated in the plan of division, or if the division constitutes a fraudulent transfer with respect to such liabilities. In addition, for LLCs formed prior to Aug. 1, 2018, that are parties to written agreements entered into prior to Aug. 1, 2018, containing restrictions, conditions or prohibitions on mergers, consolidations or asset transfers, such provisions shall be deemed to apply to a division as if it were a merger, consolidation or asset transfer. Parties that enter into agreements with LLCs on or after Aug. 1, 2018, that desire to restrict, condition or prohibit divisions must specifically provide for such restriction, condition or prohibition in their agreements. The amendments provide further protection for creditors by requiring a division contact to be named in the certificate of division. The division contact must provide any creditor of the dividing company with the name and address of the division company to which such creditor's claim was allocated for six years following the division.

Tax Implications

A division can be treated as a tax-free transaction in certain circumstances, including, for example, a division used to effectuate a pro rata spinoff to existing members. Because the amendments to the Delaware Limited Liability Company Act, or DLLCA, specifically provide that the allocation of assets in a division is not deemed a transfer or assignment, transfer taxes also may not be imposed, though the laws of each applicable jurisdiction would need to be reviewed to confirm such treatment.

Registered Series

The amendments authorize the formation of "registered series," a new type of series of an LLC. Registered series address certain issues and limitations that have arisen in connection with existing series, including (1) the inability of an existing series to obtain a good standing certificate, (2) the inability of an existing series to merge with other series of the same LLC, and (3) the fact that existing series are not considered "registered organizations" for purposes of the Uniform Commercial Code, thereby creating issues in perfecting a security interest against a series' assets.

Addressing the Limitations of Existing Series

Under the amendments, a registered series is an "association" and has the attributes of a "registered organization," for purposes of the UCC, which may facilitate the use of registered series in secured financing transactions. In order to form a registered series, a certificate of registered series must be filed with the secretary of state. Accordingly, under the amendments and accompanying amendments to Delaware's UCC, the rules for filing UCC statements in Delaware against a registered series formed under the DLLCA should become simplified. While registered series will have the same rights, powers and interseries limitations on liabilities as series previously formed under Section 18-215(b) of the DLLCA, which will be known as "protected series," registered series are able to obtain good standing certificates from the secretary of state. Note that if an LLC is not in good

standing, any registered series associated with such LLC will not be able to obtain a good standing certificate. Because registered series have many of the attributes of a separate entity, and the state is required to maintain a record for registered series, an annual fee of $75 will be payable by each registered series to the secretary of state. The attributes of a protected series will remain unchanged, and thus no annual fee will be payable by a protected series to the secretary of state.

Conversion and Merger of Registered Series

A protected series can convert to a registered series by filing a certificate of conversion and a certificate of registered series. Similarly, a registered series is able to convert back to a protected series. Conversion requires the approval of members holding 50 percent of the profits of such series (unless otherwise provided in the LLC agreement). Additionally, one or more registered series of an LLC may merge or consolidate with or into one or more other registered series of the same LLC, a more practical way to combine the assets and liabilities of two series than previously available under applicable law (i.e., transferring all assets and liabilities). The merger of a registered series must be approved in accordance with the LLC agreement or, if the LLC agreement is silent, then by members holding more than 50 percent of the interest in profits of each merging series. The plan of merger of two registered series could amend a provision of the LLC agreement that relates only to the constituent registered series, without obtaining the vote required by the LLC agreement for an amendment to the LLC agreement.

Additional Considerations

Notwithstanding the amendments, it remains unclear how, and to what extent, the separateness of series will be respected by courts outside Delaware. A bankruptcy court, for example, may not apply Delaware law regarding the separateness of the series and could consolidate the assets of separate series in the event of a bankruptcy. Similarly, courts of other states may not honor the internal affairs doctrine and apply Delaware law if a suit is brought outside Delaware. The Uniform Protected Series Act has been approved by the Uniform Law Commission, which may result in more states having series provisions. This development could increase the likelihood of a court in an adopting jurisdiction correctly interpreting Delaware law and respecting separateness of series.

Statutory Public Benefit LLCs

The amendments to the DLLCA provide for the formation of statutory public benefit LLCs which, like public benefit corporations, are intended to produce a public benefit and operate in a responsible and sustainable manner. Examples of public benefits include effects of an artistic, charitable, cultural, economic, educational, environmental, literary, medical, religious, scientific or technological nature. A statutory public benefit LLC permits a for-profit LLC to balance the members' pecuniary interests with the public benefit to be promoted by the statutory public benefit LLC (as set forth in its certificate of formation) and the best interests of those materially affected by the statutory public benefit LLC's conduct.

The managers, members or other persons managing the business and affairs of the statutory public benefit LLC are required to balance the members' pecuniary interests with the stated public benefit, though there is no personal liability for monetary damages for failure to balance such interests in accordance with this provision. Fiduciary duties of the statutory public benefit LLC may otherwise be modified or eliminated, though the ability to restrict duties is more limited than in LLCs generally.

The amendments impose a two-third member voting requirement for a statutory public benefit LLC seeking to amend its certificate of formation in order to revise the statement of its public benefit, merge into an entity that is not a statutory public benefit LLC (or similar

entity) or otherwise cease to be a statutory public benefit LLC. The amendments correspond to provisions of the Delaware General Corporation Law, or DGCL, that relate to public benefit corporations, though formation of a statutory public benefit LLC is not the exclusive means of forming an LLC operated for a public benefit. The amendments provide an additional structure for the increasingly popular goal of seeking to balance pecuniary interests with a public benefit.

Cancellation of LLC Upon Abuse of Powers

Under the amendments, the Delaware attorney general may file a motion in the court of chancery to cancel the certificate of formation of any LLC for abuse or misuse of its powers, privileges or existence. Upon any such cancellation, the court has the power to appoint trustees, receivers or otherwise wind up the LLC's affairs. This new Section 18-112 corresponds to newly amended Section 284 of the DGCL, which provides a similar process for terminating a corporation for abuses.

Blockchain Maintenance of Records and Electronic Transmissions

The amendments to the DLLCA and the Delaware Revised Uniform Limited Partnership Act provide specific statutory authority for LLCs and LPs to use networks of electronic databases, known as blockchains or distributed ledgers, to create and maintain LLC or LP records, as applicable. These amendments correspond to last year's amendments to the DGCL relating to blockchain technology and will allow for the use of this new technology in connection with the governance of LLCs.

Application of 'Market Out' Exception to Appraisal Rights for Section 251(h) Mergers

The amendments to DGCL Section 262(b) apply the "market out" exception to the availability of statutory appraisal rights for back-end mergers consummated pursuant to Section 251(h) following an exchange offer without a vote of stockholders. Previously, Section 262(b)(3) provided that appraisal rights were available for mergers effected pursuant to Section 251(h) so long as any shares were held by persons other than the parent. This differs from mergers generally, in which appraisal rights are not available for shares of any class or series of stock of a target corporation that are listed on a national securities exchange or held of record by more than 2,000 holders if the merger consideration for such shares consists solely of (1) stock of the surviving corporation or any other corporation (or depositary receipts in respect thereof) that is listed on a national securities exchange or held of record by more than 2,000 holders, (2) cash in lieu of fractional shares or depositary receipts, or (3) any combination of the foregoing. However, this "market out" exception did not apply to mergers effected pursuant to Section 251(h). As a result, Section 251(h) rarely was utilized in acquisitions where the merger consideration paid to target stockholders is shares of stock. Mergers effected after Aug. 1, 2018, under Section 251(h) following a stock-for-stock exchange offer of publicly traded shares will receive treatment for appraisal rights equal to that afforded to holders in one-step acquisitions where a vote of target stockholders is required to approve the merger.

Information Required by Appraisal Statement

The amendments to Section 262(e) modify the information to be included in the statement that must be furnished to dissenting stockholders upon their request in connection with Section 251(h) mergers. Previously, Section 262(e) required that the statement to dissenting stockholders provide the aggregate number of shares not voted in favor of the merger and for which appraisal rights were demanded, and the aggregate number of holders of such shares. In recognition of the fact that no shares are "voted" for the adoption of the merger agreement in a Section 251(h) transaction, the amendments clarify that the surviving corporation must provide stockholders, upon their request, with the

number of shares not purchased in the tender or exchange offer, rather than the number of shares not voted for the merger.

Ratification of Defective Corporate Acts

Several amendments have been made to Section 204, originally adopted in 2014 to provide a mechanism for a corporation to ratify defective corporate acts. First, the amendments confirm that Section 204 remains available for ratifying defective corporate acts in circumstances where no shares of valid stock are outstanding. This amendment eliminates the need for any stockholder vote on the ratification of a defective corporate act in such circumstances, even if a vote of stockholders would otherwise be required under Section 204.

Second, the amendments clarify that, in cases where a vote of stockholders is required for the ratification of a defective corporate act, the notice of the stockholder meeting required to be given to holders of valid or putative stock may be given to such holders as of the record date for the defective corporate act if it involved the establishment of a record date. This change will facilitate a corporation's ability to use the ratification mechanisms in Section 204 since most corporations, especially large ones, are more likely to have a list of stockholders as of the record date for the defective corporate act. The amendments also allow public companies to give such notice to such stockholders through disclosure in a proxy statement or other document publicly filed with the U.S. Securities and Exchange Commission pursuant to Section 13, 14 or 15(d) of the Securities Exchange Act.

Next, the amendments clarify and confirm that any act or transaction that a corporation takes that is within its power under the DGCL may be ratified under Section 204 if such act or transaction was void or voidable due to a "failure of authorization." Such amendment is intended to eliminate any implication arising from Nguyen v. View Inc.[1] that an act or transaction may not be within the power of a corporation — and therefore may not constitute a "defective corporate act" susceptible to cure by ratification — solely on the basis that it was not approved in accordance with the provisions of the DGCL or the corporation's certificate of incorporation or bylaws. The amendments, however, do not alter the power of the court of chancery to decline to validate a defective corporate act that has been ratified under Section 204 on the basis that the failure of authorization that rendered such act void or voidable involved a deliberate withholding of any consent or approval required under the DGCL, the certificate of incorporation or bylaws.

Finally, the amendments clarify that the failure of an act or transaction to be approved in compliance with disclosures in any proxy statement or consent solicitation statement may constitute a failure of authorization. Thus, an act or transaction alleged to be defective due to deficiencies in the disclosure documents whereby the vote or consent of stockholders to such act or transaction was sought may be cured through ratification pursuant to Section 204.

Forfeiture of Charter

The amendments also modify Section 284 to make clear that the Delaware attorney general has the exclusive authority to move for the revocation or forfeiture of a corporation's charter for abuse, misuse or non-use of its corporate powers, privileges or franchises by filing a complaint in the court of chancery. Furthermore, as amended, Section 284 provides that the court of chancery has the power to appoint a trustee to administer and wind up the affairs of a corporation whose charter has been revoked or forfeited pursuant to Section 284.

Allison L. Land is a partner and Anne E. Connolly is an associate at Skadden Arps Slate

Meagher & Flom LLP.

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[1] Nguyen v. View Inc. CA, No. 11138-VCS (Del. Ch. June 6, 2017)

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