THE DOCTRINE OF INDEPENDENT LEGAL SIGNIFICANCE APPLIES TO ALTERNATIVE ENTITIES: SOME THOUGHTS FOR LENDERS

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Recently, the Delaware legislature amended the Delaware Limited Partnership Act (the "LP Act") and the Delaware Limited Liability Company Act (the "LLC Act") to clarify that the doctrine of independent legal significance applies to Delaware limited partnerships ("LPs") and limited liability companies ("LLCs"), respectively. *See* Del. Code Ann. tit. 6. §§ 17-1101(h), 18-1101(h). While the doctrine has long been utilized by Delaware courts in construing provisions of the Delaware General Corporation Law (the "DGCL"), whether the doctrine applied to the construction of alternative entity statutes was an "open question." *Twin Bridges Ltd. P'ship v. Draper*, C.A. No. 2351-VCP, 2007 Del. Ch. LEXIS 136, at *34 n.47 (Del. Ch. Sept. 14, 2007). The legislature's recent amendments have now answered that question, but in so doing, have brought to the fore certain questions for lenders and others who deal with alternative entities.

The Doctrine of Independent Legal Significance

The doctrine of independent legal significance provides that a legal action validly taken under one section of a given statute (traditionally the DGCL) need not satisfy the requirements of another section of that statute to be valid, even if the ultimate result of the legal action would be the same under either section. For instance, while an amendment to the certificate of incorporation that alters the rights of shares of a given class requires approval by a separate vote of that class under DGCL § 242, such an amendment may be accomplished without such a vote by means of a merger under DGCL § 251. *See, e.g.*, Elliott Assocs., L.P. v. Avatex Corp., 715 A.2d 843, 853 n.48 (Del. 1998). Using the same example in the alternative entity context, unless otherwise stated in the agreement, the terms of an LP or LLC agreement may be amended by satisfying the requirements for a merger under the existing agreement, even if the agreement imposes more stringent requirements for amendments. *See also* Del. Code Ann. tit. 6 §§ 17-211(g), 18-209(f).

Amendment via Merger

To the extent that an LP or LLC agreement imposes a less onerous barrier to a merger than to a direct amendment, a merger provides a more viable "backdoor" method of amending the agreement. Because of the remarkable flexibility that alternative entities provide, the ramifications of such an amendment method are perhaps greater than in the case of corporations. Delaware alternative entities can be designed in virtually any manner imaginable, and frequently contain provisions upon which lenders and others rely in entering into transactions with such entities, including provisions related to Uniform Commercial Code ("U.C.C.") Article 8 opt-in, independent directors, and separateness covenants. While an LLC agreement (or LP agreement) may restrict the ability to amend the terms of the agreement directly, where the possibility of amending the agreement by way of merger was not anticipated and similarly restricted, an amendment by merger might be more easily accomplished than a direct amendment. An unanticipated amendment to an agreement in this manner may result in serious consequences for lenders and others, as illustrated below.

Special Purpose Entities

Special purpose entities ("SPEs") are used in a variety of contexts, but they appear most often in structured finance and securitization transactions. In such transactions, SPEs typically have the following characteristics:

- The SPE's purpose is narrowly defined, which limits its authority to engage in activities outside of its intended purpose;
- The SPE's terms contain separateness covenants to avoid substantive consolidation in the event a related entity files for bankruptcy;
- The SPE has an "independent director" whose consent is necessary for the entity to make a voluntary bankruptcy filing;

- The independent director's fiduciary duties are limited to protecting the interests of one or more interested parties (typically a lender).

Because of the flexibility permitted by the LLC Act, Delaware LLCs are ideally suited for use as SPEs. LLCs can be structured to have a limited purpose, to prohibit undesirable actions by members or managers, and to tailor the rights and obligations of the independent director to the needs of a particular transaction.

Independent Director

The LLC Act provides that an LLC agreement may grant managers specific rights and duties, including the right to vote. Del. Code Ann. tit. 6 § 18-404(a), (b). As a result, bankruptcy remote LLCs can be created with a special manager – the independent director – who lacks any authority other than to consent to (or decline to consent to, and thereby prevent) the voluntary bankruptcy filing of the LLC. Moreover, fiduciary duties in LLCs, unlike as in corporations, can be expanded, limited, or eliminated by inserting relevant contractual provisions into the LLC agreement. Del. Code Ann. tit. 6 § 18-1101(c). One consequence of such limitation or elimination is that the independent director can focus on its obligations to a lender without fear of conflicting obligations to others who might have an interest in the entity. However, if the LLC agreement permits the LLC to merge without the consent of the independent director, the role of independent director could potentially be eliminated or altered such that the independent director would have potentially conflicting fiduciary duties to both creditors and equity holders under an amended agreement to which he did not consent!

Article 8 Security Opt-In

Although an interest in a limited liability company may be certificated or uncertificated, the mere fact than an interest is certificated does not make it a "certificated security" for purposes of Article 8 of the U.C.C. "An interest in a partnership or limited liability company is not a security unless it is dealt in or traded on securities exchanges or in securities markets, its terms expressly provide that it is a security governed by this Article, or it is an investment company security." U.C.C. § 8-103(c). Thus, for most limited liability companies, a certificated LLC interest will not be a certificated security for purposes of the U.C.C. unless its terms expressly state that it is governed by Article 8 of the U.C.C. Expressly stating that a certificated LLC interest is governed by Article 8, or "opting in" to Article 8, provides several advantages to purchasers, including secured parties,[i] such as allowing a party to avail itself of protected purchaser status[ii] and providing alternative, and preferred, methods for perfecting security interests other than the simple filing of a financing statement.

Perfection of Security Interests

Unless a security interest is perfected, a bankruptcy trustee has authority to avoid the security interest and relegate the secured party's claim to an unsecured claim in bankruptcy. 11 U.S.C. § 544(a)(1). If an LLC has not opted in to Article 8, the LLC interest would likely be a general intangible and a security interest in such could only be perfected by filing a financing statement. U.C.C. § 9-310(a). A security interest in a certificated security, however, may be perfected not only by filing a financing statement, but also by delivery or control. U.C.C. §§ 9-310, 9-312(a), 9-313(a), 9-314(a).

Consequences for Lenders

Regardless of whether an LLC opts in to Article 8 initially, the ramifications to secured parties from an unanticipated amendment to the LLC agreement are potentially severe. For example, suppose that Article 8 does not apply to an LLC interest (that is, it is not a security), and a merger occurs whereby the LLC agreement of the surviving LLC contains Article 8 opt in language. Presumably a secured party would have filed a financing statement to perfect its security interest before the merger, but the secured party may be unaware that a merger occurred. Suppose that the surviving LLC issues certificated securities, and a third party obtains a security interest in the LLC interest and perfects by obtaining control. Even though the first secured party had filed a financing statement before the third party perfected its security interest, the third party's security

interest would have superior priority. U.C.C. § 9-328. Moreover, the first secured party would not have been able to perfect its security interest by control unless it had required that the LLC opt in to Article 8. Even if the first secured party had taken steps to prohibit amendment of the LLC agreement without its consent to avoid a situation similar to the one described, it would not prevent an amendment by merger unless the prohibition explicitly included an amendment by merger.

A lender may face unintended consequences from a merger even where the lender requires that the LLC initially opt in to Article 8. For instance, if an LLC agreement contains opt in language, and a third party has already filed a financing statement against an LLC interest, a lender might feel confident that he can obtain a senior lien by taking control of the certificated security representing the interest in the LLC, and so long as Article 8 applies to the LLC, he would be correct. *See* U.C.C. § 9-328. However, should the LLC be amended to remove the opt in language, control would no longer be a valid method of perfection. At best, the lender's priority would become subordinate to that of the third party (for example, if the lender had filed a financing statement as well as taking control). At worst, the lender's security interest would be unperfected and subject to avoidance in the event of bankruptcy.

These are just a few examples of how the application of the doctrine of independent legal significance may result in unintended consequences for lenders and others if an agreement has not been structured with the possible application of the doctrine in mind. As illustrated by these examples, whether terms bargained for ex ante are more ephemeral than initially believed is an inquiry well worth the attention of lenders. Thus, when dealing with Delaware LLCs or LPs, it is always best to keep in mind that the doctrine of independent legal significance applies, so that even if an agreement restricts the ability of parties to do something directly, it does not necessarily prevent them from doing it indirectly.

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[i] The UCC defines the term purchaser to include secured parties. *See* U.C.C. § 1-201(b)(29), (30).

[ii] A purchaser of a certificated interest in an LLC that qualifies as a security under Article 8 will be considered a protected purchaser if (i) the purchaser gives value for the security, (ii) does not have notice of any adverse claim to the security, and (iii) obtains control of the security. U.C.C. § 8-303(a).