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THIRD-PARTY DELAWARE OPINIONS FOR STRUCTURED FINANCE AND OTHER COMMERCIAL TRANSACTIONS

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INTRODUCTION

With the continued use of structured finance transactions and the use of Delaware limited liability companies and Delaware Statutory Trusts in those transactions, opinion letters on Delaware law are today often required by real estate lenders and loan rating agencies.²

Limited liability companies and certain business trusts are widely recognized as entities of choice to provide direct interests in real estate with flexibility in organization, limited liability and favorable tax treatment. These entities facilitate the exchange of like-kind property under IRC § 1031.³ They are widely used in structured finance and other secured finance transactions.

Delaware law opinion letters provide both lenders and rating agencies comfort, on top of bankruptcy-remote requirements placed on a borrowing entity, that the entity was validly formed, that it duly authorized the transaction, and that the entity and the mortgaged property generating the cash flow to investors have been separated from other entities, assets, properties, and liabilities.⁴

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² For a discussion of the contents of all opinions, *see generally* Committee on Legal Opinions and the TriBar Opinion Committee, *THE COLLECTED ABA AND TRI-BAR REPORTS* (American Bar Association 2009).

³ See Treas. Regs. §301.7701-(3) (b) (1) (single member limited liability companies); IRS Ltr. 199911033 (multiple-member limited liability companies); and Rev. Rul. 2004-86, 2004-33 I.E.B. 191 (8/16/2004) (Delaware Statutory Trusts).

⁴ While lenders and loan rating agencies have been willing to accept opinions from non-Delaware attorneys concerning Delaware corporate law because historically almost all commercial lawyers have had some training in Delaware corporate law, opinions from members of the Delaware Bar have been required on LLCs and DSTs acting as borrower/fee owners, tenants, management companies, etc.

WHY DELAWARE?

Delaware nurtures business entities.

Delaware, the "Corporate Capital", has been the forum of choice for formation of business entities for over 100 years. While limited liability companies and business trusts are found in many other jurisdictions, Delaware LLCs ("LLCs") and Delaware Statutory Trusts ("DSTs") have become the vehicle of choice in many real estate ventures. The number of Delaware LLCs has grown to exceed the number of corporations in Delaware. The Delaware limited liability statute was enacted in the mid-1980s and while it was a popular vehicle for Delaware businesses, following 1996, when Delaware amended the statute to better reflect the needs of the business/financial community, the use of Delaware LLCs by investors around the country skyrocketed. According to the Delaware Secretary of State's Division of Corporations, as of March 29, 2013 there were 1,001,200 business entities domiciled in Delaware (up from 675,000 in September 2006). Of these, 257,598 were domestic corporations, 76,641 were domestic limited partnerships, and 23,094 were statutory trusts. 643,867 were limited liability companies, representing a more than 100% increase since early 2006. Delaware has adapted and expanded the concept of "flexibility" from its corporate and contract laws to its laws creating and enabling these entities.

Business trusts were commonly used during much of the 19th and 20th centuries to hold real property in areas where corporations were prohibited.⁵ However, the traditional form of business trust was too restrictive for great usefulness in the modern business environment. The Delaware Statutory Trust Act combines the traditional form of business trust with the flexibility of organization and management that Delaware traditionally (and increasingly) grants to business entities. It is used together with a "Springing LLC" to provide the continuity of existence in the event of default.

Easy Administrative Procedures.

The Division of Corporations of Delaware's Department of State is renowned for its state-of-the-art capabilities which facilitate a broad range of filing and business activities for all Delaware business entities.⁶ The website provides online services that include:

- Filing of UCC documents.
- Payment of franchise taxes.
- Access to relevant provisions of the Delaware Code.⁷

⁵ For a full history of statutory trusts and similar entities, see Charles J. Durante and Brian M. Gottesman, *et al.*, DELAWARE STATUTORY TRUSTS MANUAL (Matthew Bender, 2010).

⁶ <http://www.state.de.us/corp/default.shtml>.

⁷ <http://www.state.de.us/corp/DElaw.shtml>.

- Help with finding a registered agent.⁸
- An entity search engine.
- Name reservation for new entities.
- Expedited, same day service.⁹
- Status check for Delaware entities.¹⁰
- Some Delaware registered agents have direct connections to the Division of Corporation's electronic database and can file entity formation documents electronically.

Expertise of judiciary in business matters.

Delaware judiciary and legal system is consistently voted the best in the United States by the Harris Poll conducted for the Institute for Legal Reform of the U.S. Chamber of Commerce annual poll of corporate attorneys and general counse1.¹¹

Delaware's Court of Chancery is a court of limited jurisdiction with particular expertise in resolving corporate and entity disputes. It is widely recognized as the preeminent court in the nation for business-related disputes.

The state-of-the-art facilities at the Division of Corporations, the flexibility of the law and the expertise of the judiciary have not occurred by happenstance. The volume of corporations and now limited liability companies and the sophistication of litigation engendered by these entities have required the Delaware Bar to be on the cutting edge of business planning. As the needs and realities of businesses have changed over the years, the Corporations Section of the Delaware State Bar Association has routinely monitored case law and business trends and generated legislation to allow the Delaware entities to accommodate those needs. As a small state, Delaware provides easy access to elected and appointed officials who recognize the need for the State to remain at the cutting edge of business organization law. With the assistance of the Bar, the Executive and Legislative branches of state government continually fine-tune the laws and regulations impacting business organizations.

Delaware defers to contract.

Delaware's LLC and DST statutory scheme offers flexibility to investors by, *inter alia*, permitting a single member LLC or an LLC with a series of members, etc. Yet it also enables the restrictions which lenders and underwriters demand by facilitating the creation of a single purpose entity ("SPE"), *i.e.*, an entity which is separate from its affiliates, owns only the subject property and has no other debt.

⁸ <http://www.state.de.us/corp/remotegts.shtml>.

⁹ <http://www.state.de.us/corp/expserv.shtml>.

¹⁰ <http://www.state.de.us/corp/onlinestatus.shtml>.

¹¹ <http://www.instituteforlegalrefonn.com/harris/>

Delaware courts rely heavily on the concept of freedom of contract.¹² Accordingly, most provisions of the LLC Act, 6 *Del. C.* § 18-101 *et seq.*, contain the following proviso: "Except as provided in a limited liability company agreement" or other similar language.¹³

The Delaware Statutory Trust Act, 12 *Del. C.* § 3801 *et seq.*, also provides great flexibility and deference to the governing instrument. *E.g.*, § 3817 [indemnification]; § 3819 [access to records]; § 3803 [limitation of liability]; § 3802(b) [contributions by beneficial owners]. Of special import is § 3805, which allows almost limitless flexibility in the establishment of the rights and powers of beneficial owners.

Case law demonstrates great deference to contract and to decisions of company management.

The business judgment rule has long been recognized in the corporate context. In essence, there is a rebuttable presumption by the court that directors acted in good faith and with due care.¹⁴ Furthermore, the court does not impose itself unreasonably on business affairs of corporation.¹⁵

Delaware courts give great deference to the decisions of corporate managers.¹⁶

Favorable state tax treatment.

Federal "pass-through entities" are "pass-through entities" for Delaware income tax purposes.¹⁷ Delaware follows the federal "check the box" election for taxing the income of an LLC.¹⁸ Non-pass-through entities pay Delaware's state income tax only on income

¹² *Cantor Fitzgerald, L.P. v Cantor*, 2000 Del. Ch. Lexis 43, (Del. Ch. March 13, 2000), *appeal dismissed*, 755 A.2d 387 (Del. 2000).

¹³ *E.g.*, 6 *Del. C.* § 18-107; § 18-108; § 18-213(b); § 18-304 [bankruptcy]; § 18-402 [management]; § 18-404 [classes and voting]; § 18-803 [winding up]. While this outline is generally confined to LLCs and DSTs, the Delaware Revised Uniform Partnership Act, 6 *Del. C.* §§ 15-101 *et seq.* and the Delaware Revised Uniform Limited Partnership Act, 6 *Del. C.* §§17-101 *et seq.*, follow a similar statutory scheme to the LLC Act and many similar, if not identical, provisions are applicable to those entities.

¹⁴ *E.g.*, *McMullin v. Beran*, 765 A.2d 910 (Del. 2000); *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984).

¹⁵ *Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345 (Del. 1993).

¹⁶ *In re Walt Disney Co. Deriv. Litig.*, 2005 WL 2056651, at *14-15 (Del. Ch. Aug 9, 2005); *In re Compucom Systems, Inc. Stockholders Litig.*, 2005 WL 2481325 (Del. Ch. Sep. 29, 2005).

¹⁷ 30 *Del. C.* § 1605 (a).

¹⁸ 30 *Del. C.* §§ 1621 *et seq.*

sources in the state of Delaware.¹⁹ Delaware's franchise taxes are limited, *e.g.* \$250.00 annually per LLC.²⁰

THE DELAWARE OPINION LETTER

The Delaware LLC and DST opinions require careful review of documents and knowledge of the specific entity acts and case law. Like all legal opinions, they are time sensitive.

Documents required to give a Delaware opinion.

To avoid last minute holdups, copies of all documents (as well as any changes to drafts of documents) should be provided to counsel as soon as possible. Executed "Entity Documents" (generally in PDF or facsimile copy) are required to give an opinion of validity and good standing or authority to file voluntary bankruptcy (see below). These documents include:

- A Certificate of Good Standing from the Delaware Secretary of State for each entity.
- A certified copy of the Certificate of Formation or Certificate of Trust from the Delaware Secretary of State for each entity.
- A fully executed limited liability company agreement (sometimes called an operating agreement) or trust governing instrument for each entity.

It is NECESSARY to provide Delaware counsel with drafts before the documents are finalized. This helps avoid "carve outs" in the opinion or amendments of documents should the limited liability company agreement (or Certificate of Formation) include language which would not be valid or enforceable under Delaware law.

Copies of all "Loan Documents" are required for most other opinions which are generally requested by the lender and the rating agency, even if the Delaware counsel is not opining on the enforceability of such Loan Documents (because, for example, they are governed by the law of a different state). To expedite the opinion, unexecuted drafts are frequently reviewed, subject to receipt of executed final drafts at the time of closing. A potential delay exists in release of the opinion when lender's counsel requests reference to documents "executed by" the parties in the opinion when those documents will not be executed until the date of closing.

There is no set list of documents that must be reviewed by Delaware counsel; the number and nature of the documents reviewed depends largely on the wishes of the Lender. Generally Delaware counsel will be asked to review the relevant note, mortgage instrument, and loan agreement, as well as other transaction or title documents, assignment or assumption documents, etc.

¹⁹ 30 *Del. C.* §§ 1121 et seq. (individual); 30 *Del. C.* § 1902 (corporate).

²⁰ <http://www.state.de.us/corp/frtax.shtml>

Contents of the Opinion Letter.

The opinion letter should provide the reader the sufficient background for the opinions rendered. Among other things, the letter should:

1. Describe the limited role of the opinion giver as special Delaware counsel.
2. Identify the client and all entities covered by the opinion and the role played by each such entity in the transaction, *i.e.*, borrower, leasing company, management company, member, guarantor, etc.
3. Identify any other entities and/or persons executing any of the documents.²¹
4. Identify all documents which were reviewed in order to generate the opinions set forth in the letter.²²
5. Be dated as of the date of the transaction.
6. Separately enumerate each and every opinion offered.
7. Describe all assumptions, limitations and qualifications.

Opinions Provided

The Delaware LLC and DST opinion letters generally include multiple opinions on Delaware law.

The Duly Formed, Validly Existing and Good Standing Opinion.

Opinions regarding the valid formation and good standing of the LLC and DST borrowers are always requested. These opinions require careful review of the Entity Documents.

EXAMPLE:

Each of the Delaware Entities is a limited liability company that has been duly formed and is validly existing and in good standing under Delaware law and is a legal entity separate and apart from its Members.

LLCs are hybrid entities that combine desirable characteristics of corporations, limited partnerships and general partnerships.²³ LLC's may have one or more members (the "Single Member LLC").²⁴ Although not as common as the Single

²¹ The opinion letter should be careful to make certain that these entities and/or persons are not covered by the opinion.

²² Dates of some documents are relevant. They provide limitations as to the time frame of the opinion, *e.g.*, a "stale" Certificate of Good Standing should not be the basis of an opinion.

²³ *Great Lakes Chem. Corp. v. Monsanto Co.*, 96 F. Supp. 2d 376 (D. Del. 2000).

²⁴ 6 *Del. C.* § 18-101(6).

Member LLC, LLCs may have a series of members, managers or limited liability interests with separate interests each of which can be held separate from the assets and liabilities of other series.²⁵

Formation of an LLC in Delaware is a simple procedure. LLCs are formed by filing a certificate of formation with the Delaware Secretary of State *by an authorized person*.²⁶ This presumes that the limited liability company agreement, i.e., the agreement that sets forth the details of the operations of the entity, pre-dates the filing. The certificate of formation must include:

- name of the LLC;
- address of registered office; and
- name and address of registered agent.²⁷

The Certificate of Formation may include other matters determined by the members. Occasionally, lenders will ask to include additional provisions (such as SPE provisions) in the Certificate of Formation as well as the LLC Agreement. This practice is not recommended as it provides no additional protection to the Lender (unlike a corporation, there is no provision that must be included in an LLC's Certificate of Formation, as opposed to its LLC Agreement, in order to be effective, and the inclusion of such provisions are not considered notice under the Delaware LLC Act).²⁸ Moreover, inclusion of such provisions in the Certificate of Formation will result in unnecessary additional expense for the Borrower should they wish to engage in other business after the satisfaction of the Loan (as they will have to file a revised Certificate).

Filing of the certificate is effective legal notice of the entity's existence. No other filing or publication is required. One of the advantages of a Delaware LLC is confidentiality. An LLC is not required to publicly file its limited liability company agreement, its membership roster, and/or its capital and organizational structure. It need only file sufficient information publicly to put the public on notice of its formation, *i.e.*, the certificate of formation.

A DST is formed pursuant to a written governing instrument, i.e., the trust agreement, and the filing of a certificate of trust with the Delaware Secretary of State. There are only three requirements in a certificate of trust.

- name of the DST;

²⁵ 6 Del. C. § 18-215.

²⁶ 6 Del. C. § 18 204.

²⁷ 6 Del. C. § 18-201.

²⁸ Moreover, because the LLC Agreement is often the subject of negotiation right up until the date of closing, such provisions may further complicate matters if they do not match exactly with the language of the final LLC Agreement.

- address of at least one trustee; and
- date of effectiveness if different from the date of filing.²⁹

The DST must always have at least one Trustee residing, incorporated, or otherwise situated in the State of Delaware.³⁰ This requirement is sometimes met by having a person or entity in Delaware serve as a nominal “Delaware Trustee” with limited or no management authority.

The DST has perpetual existence unless a finite time-frame is specified in its organizing papers. Death, incapacity, dissolution, termination or bankruptcy of the beneficial owner will not terminate the DST.³¹

Unlike LLCs and corporations, the DST requires no franchise or other annual tax. However, the fees associated with engaging a professional Delaware trustee are typically dramatically higher than those for a Delaware registered agent of an LLC or corporation.

While the statute requires no specifics in the governing instrument, the document is generally lengthy and contains detailed provisions regarding the management and existence of the trust.

When validly formed and in good standing, both a Delaware LLC and a DST are separate and apart from their respective members, managers, beneficial owners and trustees. *E.g.*, 6 Del. C. §18-201(b); 12 Del. C. § 3810.

Opinions Regarding Due Authority and Authorization.

Opinions that the subject LLC and/or DST has the authority to enter into the transaction, has authorized entry into the transaction and execution and delivery of the Loan Documents and no other action by anyone is required, are almost always requested. Again these opinions require careful review of the Entity Documents and review of the Loan Documents to be certain that this transaction has been duly authorized.

EXAMPLES:

Each of the Delaware Entities has power and authority under Delaware law and the Entity Documents to execute, deliver and perform its respective obligations under the respective Loan Documents to which it is a party.

Under Delaware law and the Limited Liability Company Agreement of each Delaware Entity, the execution and delivery by such Delaware Entity of each of the Loan Documents to which it is a party, and the performance by each

²⁹ 12 Del. C. § 3810.

³⁰ 12 Del. C. § 3807.

³¹ 12 Del. C. § 3808.

Delaware Entity of its respective obligations thereunder, have been duly authorized by all necessary limited liability company action on the part of such Delaware Entity.

No consent, approval or other authorization of or registration, declaration or filing with, any court or governmental agency or commission of the State of Delaware is required in connection with the execution or delivery by each of the Delaware Entities of the respective Loan Documents to which it is a party, or the performance by such Delaware Entity of its respective obligations thereunder.

The execution and delivery by each Delaware Entity of the respective Loan Documents to which it is a party, will not (i) result in a breach or violation of any law or governmental rule or regulation of Delaware applicable to the parties thereto and now in effect, or (ii) conflict with or violate the applicable Entity Documents of such Delaware Entity.

The authority opinions require a review of the entity's governing instrument or operating agreement. The member or members of an LLC enter into a limited liability company agreement which governs the management of the company.³² While the limited liability company agreement can be oral or written, a written limited liability company agreement is a prerequisite for any opinion.

The limited liability company agreement delineates the power and authority of the LLC to enter into a given transaction. The limited liability company agreement is granted almost plenary deference by both the statutes and the courts. Almost all provisions of the LLC Act permit the limited liability company agreement to establish procedures and structures different from those set out in the LLC Act itself. Only on rare occasion does the statute trump the limited liability company agreement. Absent any illegal provisions in the limited liability company agreement, or provisions that are void for public policy reasons (which see further below), the courts generally view the limited liability company agreement as a contract and accord it the same regard that they traditionally grant other contractual agreements.

Management is generally in the hands of members; however, members may at their discretion establish managers and other governing entities to control day-to-day functions. Such managers are vested with whatever powers are granted in the limited liability company agreement. Different managers or classes/groups of managers may be vested with different spheres of authority. A board of directors is not required; however, it may be utilized as a management body. This was frequently done when LLCs were a relatively new form of entity because investors were familiar and comfortable with the traditional corporate structure, but today is quite rare as most people are comfortable with the member/manager structure envisioned in the LLC Act. The limited liability company agreement may also designate officers or agents to carry out

³² 6 Del. C. § 18-201(d).

the functions of the LLC.³³

The beneficial owners and the trustee(s) of a DST enter into a written "governing instrument," consisting of one or more documents, which creates the trust or provide for the governance of its business affairs and conduct of business.³⁴ Like the limited liability company agreement for LLCs, the governing instrument is granted almost plenary deference by both the statutes and the courts. Almost all provisions of the DST Act permit the governing instrument to establish procedures and structures different from those set out in the DST Act itself or the Certificate of Trust.³⁵ With rare exceptions, the governing instrument defines the power and authority of the DST to enter into the transaction that is the subject of the opinion.

The Management of a DST is typically conducted by trustees; however, as with LLCs, the DST Act allows almost limitless flexibility. Each DST may design a management organization that best meets its needs, with officers, managers, etc. Such organization members are vested with whatever powers are granted in governing instrument. Different trustees or classes/groups of trustees may be vested with different spheres of authority.³⁶

Opinions Regarding Limitations on Authority.

Subsumed in the opinions on authority are opinions regarding the legality of limitations on the LLC's or DST's authority. Sometimes, however, a lender will request an opinion as to a specific limitation. Such limitations are generally inserted into the limited liability company agreement or governing instrument as required by lenders and underwriters. Most common are the Single Purpose Entity ("SPE") limitations. Some examples of SPE provisions in a limited liability company agreement are discussed in more detail below. These provisions should be carefully reviewed when proffering an opinion.

EXAMPLE:

If properly presented to a Delaware court, a applying Delaware law, would conclude that (i) for as long as any obligation is outstanding, in order for a person to file a voluntary bankruptcy petition on behalf of the Company, the written consent of the Independent Manager as provided for in section ___ of the limited liability company agreement, is required, and (ii) such provision, contained in section ___ of the limited liability company agreement, that require, for as long as any obligation is outstanding, the unanimous written consent of the Independent Manager in order for a person to file a voluntary bankruptcy petition on behalf of the Company, constitutes a legal, valid and binding agreement of the Member, and is enforceable against the Member in accordance with its terms.

³³6 Del. C. § 18-402.

³⁴ 12 Del. C. §3801, 3808.

³⁵ E.g., 12 Del. C. §3801.

³⁶ 12 Del. C. §3806.

While Delaware LLCs and DSTs may be organized for any lawful purpose (except some insurance-related purposes as to LLCs) lenders and underwriters often require that the LLC or DST be restricted to having only a single purpose. Thus SPE provisions are imposed to set limitations on how business is conducted. Some common SPE provisions include:

- Prohibitions against the acquisition or ownership of any material asset other than (i) the property that is the subject of the proposed transaction (the "Property"), and (ii) such incidental personal property as may be necessary for the operation of the Property.
- Prohibitions or restrictions on the company's ability to take on additional debt.
- Requirements that the company at all times maintain its separate existence and good standing and refrain from certain types of amendments to its governing documents, fail to preserve its existence as an entity duly organized.
- Restrictions or outright prohibition of the company acquiring any subsidiaries, merging with or consolidating with another entity, or commingling any of its assets with those of any other entity, including parent companies and affiliates.
- Requirements that the company pay its own debts from its own assets and maintain its own separate books and records.
- Provisions forbidding the company from serving as guarantor for another entity's debts or obligations.³⁷

Some restrictions are not permissible. For example, blanket prohibitions against filing bankruptcy or requiring the Lender's consent before seeking or consenting to a bankruptcy petition is void (as to both LLCs and DSTs) on public policy grounds.³⁸ As outlined below, some restrictions on the right to file bankruptcy are permitted.

There was for many years some question as to whether a Delaware limited liability company agreement can bar or state that the LLC waives the right to seek judicial dissolution under 6 *Del. C.* § 18-802. The wording of the statute does not contain the "unless otherwise specified in the LLC Agreement" language common among other provisions in the Act. In 2008, the Chancery Court held that a waiver of the right to seek judicial dissolution under 6 *Del. C.* § 18-802 could be enforceable if it did not interfere with the rights of third parties.³⁹ Many Delaware practitioners are still uncomfortable opining on the enforceability of such provisions.

³⁷ A DST's governing instrument may require approval of a particular trustee or beneficial owner to amend, merge, consolidate, sell, lease, transfer assets or dissolve. 12 *Del. C.* §3806(b).

³⁸ See, e.g. *In re Tru Block Concred Products, Inc.*, 27 B.R. 486 (Bankr. S.D. Cal. 1983).

³⁹ *R & R Capital, LLC v. Buck & Doe Run Valley Farms, LLC*, 2008 Del. Ch. LEXIS 115 (Del. Ch.).

If the governing instrument or operating agreement contains any impermissible clauses and after negotiation the clauses cannot be removed or modified, the Delaware opinion must carve out the enforceability of such clauses from the opinion.

The Continued Existence and Remoteness of the Property Opinion.

Lenders and underwriters require that the LLC or DST continue for so long as the loan remains outstanding and that the collateral for the loan is not tied up in protracted bankruptcy or other proceedings. Thus, the non-dissolution and continued existence of the LLC or DST is the subject of many Delaware opinions and are generally governed by the respective Act and the Entity Documents. Opinions are also frequently required regarding whether the assets of the LLC or DST may be attached in the event of a bankruptcy of the member or beneficial owner, as the case may be.

EXAMPLES:

Under Delaware law, the respective existence of each Delaware Entity as a separate legal entity shall continue until the cancellation of its respective Certificate of Formation.

Under the LLC Act, on application to a court of competent jurisdiction, a judgment creditor of the Delaware Entity's Member may be able to charge the Member's share of any profits and losses of the Delaware Entity and the Member's right to receive distributions of assets of the Delaware Entity (the "Member's Interest") with payment of the unsatisfied amount of the judgment, and the judgment creditor of the Member may not attach specific assets of the Delaware Entity directly. Thus, under the LLC Act, a judgment creditor of the Member may not satisfy its claims against the Member by asserting directly a claim against the assets of the Delaware Entity.

Under Delaware law and the Limited liability company agreement of each Delaware Entity, the bankruptcy or dissolution of the Member of such Delaware Entity will not, by itself, cause such Delaware entity to be dissolved or its affairs to be wound up.

The LLC

Membership interest in an LLC is personal property.⁴⁰ It gives the member a right to proportional share of LLC income, unless otherwise specified in the limited liability company agreement.⁴¹ It is freely assignable unless stated otherwise in the limited liability company agreement.⁴² Members have no individual property interest in LLC-

⁴⁰ 6 Del. C. § 18-701.

⁴¹ 6 Del. C. § 18-503.

⁴² 6 Del. C. § 18-702.

owned property.⁴³

Judgment creditors of a member may only charge (*i.e.*, place a lien upon) the member's membership interest in the LLC to obtain any distribution payable to the debtor but may not directly seize specific property owned by the LLC.⁴⁴ A charging order may result in causing the debtor to cease to be a member in the LLC. Delaware's Court of Chancery has jurisdiction to hear any determine any matter relating to the charging order.

Bankruptcy is broadly defined in 6 *Del. C.* 18-101 as "an event that causes a person to cease to be a member as provided in § 18-304 of this title." Under 6 *Del. C.* § 18-304, a person or entity ceases to be a member upon (except if permitted in operating agreement or approved by all other members): (1) Making an assignment for the benefit of creditors; (2) filing a voluntary petition in bankruptcy; (3) being adjudged bankrupt or insolvent; (4) filing a petition or answer seeking reorganization, arrangement, composition, readjustment, liquidation, dissolution or similar relief for the member entity; (5) filing an answer or other pleading admitting or failing to contest the material allegations of a petition filed against the member in any bankruptcy or insolvency proceeding; (6) seeking, consenting to or acquiescing in the appointment of a trustee, receiver or liquidator of the member.⁴⁵ Should the person cease to be a member, the membership interest converts to an economic interest only.⁴⁶

Members may resign and be replaced in any manner consistent with the limited liability company agreement.⁴⁷ However, if no manner of resignation is given in the limited liability company agreement, a member may not resign prior to dissolution and winding up of the LLC's affairs. On resignation, a member cannot demand a distribution in kind.⁴⁸ Instead, a member is entitled to fair market value of his ownership interest. Members of the LLC may assign all or part of their interest except where prohibited by

⁴³ Note that the defense of usury is not available with respect to any obligation of a member or manager arising under the limited liability company agreement or any note or instrument. 6 *Del. C.* § 18-505.

⁴⁴ 6 *Del. C.* §18-703. (§18-703 was amended in 2005, adding the term "charge" to clarify the lien status of such a claim).

⁴⁵ The death of a member who is a natural person will not, under the LLC Act, result in that person ceasing to be a member; the membership interest will be part of his or her estate.

⁴⁶ *Milford Power Co., v. PDC Milford Power, LLC*, 866 A.2d 738 (Del. Ch. 2004). As a result, the ipso facto bankruptcy default provision in an agreement was held to be unenforceable. *Northrop Grumman Tech. Servs. v. Shaw Group Inc. (In re IT Group, Inc)*, 302 B.R. 483 (D. Del. 2003).

⁴⁷ 6 *Del. C.* § 18-603.

⁴⁸ 6 *Del. C.* § 18-605.

the limited liability company agreement.⁴⁹ However, an assignee may not participate in management of the company unless authorized in the limited liability company agreement or by consent of all non-assigning members.

An LLC can be dissolved either as specified in the limited liability agreement, by two thirds (2/3) vote of the members, at such time as there are no remaining members; or when ordered by the Court of Chancery. Distribution of assets on dissolution of an LLC proceeds first to creditors (including members and managers who are creditors), to the extent permitted by law and then to members and former members.⁵⁰

The Special Member

The provisions of 6 *Del. C.* § 18-304 may cause a member to cease to be a member by operation of law under certain circumstances. This is particularly worrisome in situations where the LLC has only one member (as is frequently the case in commercial structured finance deals). Since an LLC with no members is dissolved automatically by operation of law, a mechanism must be put in place to continue the LLC's existence and prevent the liquidation of assets in the event of a sole member's resignation, "bankruptcy" (as broadly defined in the LLC Act), and/or assignment of interests. This is accomplished by having the Special Member "spring" into the shoes of the last remaining member of the LLC upon the occurrence of any event that would cause that person or entity to cease to be a member by operation of law or contract. Without a Special Member Delaware counsel may not opine that dissolution or bankruptcy of the Member(s) will not lead to dissolution of the LLC.⁵¹

The LLC Act permits the use of a Special Member (sometimes referred to as a "Springing Member") who is named in the limited liability company agreement and who must execute it in order to be bound to its terms. The Special Member is given specific rights and responsibilities to prevent the dissolution of the LLC caused by such a resignation or assignment. The Special Member's function is to continue the LLC until a new member is admitted.

Among the typical rights and responsibilities are that the Special Member:

- may not resign or transfer its rights unless a successor Special Member has been admitted;
- may have no interest in the profits, losses and capital of the Company;
- may have no right to receive any distributions of Company assets;
- may not be required to make any capital contributions to the Company, 6 *Del. C.* § 18-301(d);
- may not bind the Company and except as required by any mandatory

⁴⁹ 6 *Del. C.* §§ 18-701-18-705.

⁵⁰ 6 *Del. C.* §§ 18-801-18-805.

⁵¹ There is some controversy over how the LLC and the Special Member are taxed under federal tax statutes and regulations. The issue is, at the present time, unsettled.

- provision of the Act; and
- may have no right to vote on, approve or otherwise consent to any action by, or matter relating to, the Company, including, without limitation, the merger, consolidation or conversion of the Company.

The Special Member is a creature of contract, and there is no statutory restriction on who may serve (except that, in order to be effective, it should be someone other than the Member(s)). Some lenders have their own such restrictions; for example, some lenders will refuse to permit a relative of the LLC's Member or the Member's principle to serve as Special Member. These restrictions are not based on any considerations relating to Delaware statute or common law.

The Independent Manager

EXAMPLE:

The provision, contained in Section ____ of the LLC Agreement, that requires the consent of the Member and the Independent Manager in order for a Person to file a voluntary bankruptcy petition on behalf of the Company, constitutes a legal, valid and binding agreement of the Member, and is enforceable against the Member, in accordance with its terms.

The position of Independent Manager (sometimes referred to as an "Independent Director" when a "Board of Directors" provides management of the LLC) is designed to address the unenforceability of a clause prohibiting the seeking of bankruptcy without the lender's consent. It provides the lender some comfort that certain drastic actions, *e.g.*, seeking bankruptcy, may not be taken without consideration and review by a dispassionate outsider.

Generally the Independent Manager is a disinterested third party. An Independent Manager generally may not be a creditor, supplier, employee, officer, director, member or manager of the LLC; or be an employee or affiliate of the Lender (though it may take the rights of the lender and other creditors into consideration).⁵² The law permits the granting of authority over bankruptcy and dissolution issues to the Independent Manager because it, unlike the Lender, is presumed not to have any interest adverse to the LLC with regard to these matters.

While no such statutory restriction exists, most lenders will prohibit a family member of an LLC's member or affiliate from acting as Independent Manager. The Independent Manager is normally restricted in the scope of its authority to granting approval for bankruptcy or dissolution. Like the Special Member, the Independent Manager exercises no proprietary interest in the LLC, nor may it make any capital contributions. As with the Special Member, an Independent Manager may not normally resign until a successor is found. The rights of an Independent Manager are strictly limited to those set forth in

⁵² *In re General Growth Properties*, 409 B.R. 43 (Bankr. S.D.N.Y. 2009). For a full discussion of independent managers and their rights and duties, *see, e.g.*, Forrest Pearce, *Bankruptcy-Remote Special Purpose Entities*, 28 Emory Bankr. Developments J. 507 (2012).

the LLC Agreement.

The DST

The DST is a legal entity separate and apart from its trustees and its beneficial owners.⁵³ Ownership interests are considered "securities" under Article 8 of Delaware's UCC.⁵⁴ However, under *Revenue Ruling 2004-86*, they are treated as interests in real estate. Ownership may be acknowledged with trust certificates or by any other method.⁵⁵ The defense of usury is not available with respect to any obligation of a trustee or beneficiary arising under the governing instrument or any note or instrument.⁵⁶

Beneficial interests in a DST may be assigned a wide array of rights and responsibilities, depending on the terms of the trust instrument. Under Delaware law, they are considered personal property and are freely transferable unless prohibited under the trust agreement. Beneficial owners have no interest in the specific property of the DST, unless otherwise provided in the governing instrument. No creditor of a beneficial owner or trustee has any right to obtain possession of or exercise legal or equitable remedies with respect to a DST's property.⁵⁷

DST's are often formed for fixed periods of time. However, while frequently formed for a fixed term, unless otherwise specified in the trust instrument, the DST has perpetual existence.⁵⁸ Dissolution of a DST may occur upon the occurrence of a time or event specified in the trust instrument. Unless otherwise provided in the governing instrument, distribution of assets on dissolution are to creditors first and then to beneficial owners for the fair market value of their ownership interest.⁵⁹ A DST is a bankruptcy-remote vehicle which does not expire upon its beneficial owners' or trustee's bankruptcy (unlike the default rule for LLCs).⁶⁰

The Springing LLC.

In order to qualify for favorable tax treatment, the trustee of a DST cannot have any

⁵³ 12 *Del. C.* § 3810.

⁵⁴ 6 *Del. C.* § 8-103(a).

⁵⁵ 12 *Del. C.* § 3801(b).

⁵⁶ 6 *Del. C.* § 3803(d).

⁵⁷ 12 *Del. C.* § 3805.

⁵⁸ 12 *Del. C.* § 3810.

⁵⁹ 12 *Del. C.* § 3808(e).

⁶⁰ 12 *Del. C.* § 3808(b).

power to renegotiate the loan documents.⁶¹ As a practical matter this creates an obvious issue in the event of a loan default. One solution has been developed using a "springing LLC" identified in the trust instrument with a pre-approved operating agreement and manager. The springing LLC is formed at the time of the creation of the DST and "springs" into power on a default. The springing LLC has the ability to negotiate the restructuring, refinance, etc., of the loan, and then is required to enter a further transaction to assure the continuation of the tax treatment to the investor.

Opinions Relating to the Member or Manager or Beneficial Owner of the Entity.

Sometimes when an LLC is the member or manager of (or is somehow otherwise related to) an LLC or is the beneficial owner under a DST, an opinion is requested regarding the member or manager's liability for the debts of the LLC or DST, as the case may be. Such liability is governed by the respective Act or the Entity Documents.

Members and managers of an LLC are generally not liable for debts of the LLC, whether in tort or contract, solely by virtue of being members or managers.⁶² The LLC Act permits broad authority to indemnify members or managers (including the authority to advance legal fees) in the limited liability company agreement.⁶³ The LLC Act provides that a limited liability company agreement may restrict or eliminate (or expand) fiduciary duties of a member or manager and limit or eliminate liability for breaches of contract or fiduciary duties, provided that it may not eliminate the implied covenant of good faith and fair dealing or liability for a bad faith violation of that covenant.⁶⁴

Similarly, no beneficial owner, simply by virtue of his ownership, is personally liable for the debts of the DST, whether in contract or in tort.⁶⁵ A DST may indemnify and hold harmless any trustee or beneficial owner or other party from and against any and all claims and demands whatsoever, unless prohibited in the trust agreement.⁶⁶ Trust law applies unless otherwise specified in the trust instrument. 12 *Del. C.* § 3809. Therefore unless defined differently in the trust instrument of a DST, trustees of a DST will have the same fiduciary duties to the trust and to beneficial owners as would apply in a standard trust situation.⁶⁷ The right to give direction to trustees, or the exercise of that

⁶¹ *Revenue Ruling 2004-86.*

⁶² 6 *Del. C.* § 18-303. This is not to say that they might not have some liability in a separate contractual capacity; for example, as guarantors of a debt.

⁶³ *Senior Tour Players 207 Mgmt. Co v. Golftown 207 Holding Co., LLC*, 853 A.2d 124 (Del. Ch. 2004).

⁶⁴ 6 *Del. C.* § 18-1101.

⁶⁵ 12 *Del. C.* § 3803.

⁶⁶ 12 *Del. C.* § 3817.

⁶⁷ *See, e.g., 12 Del. C. §§ 3805-3806.*

right, does not create fiduciary duties on the part of the exerciser, even if he is a beneficial owner.⁶⁸

The UCC Opinion

Because perfection of a secured interest in fixtures, etc., is obtained by filing a financing statement in the domicile of the LLC or DST, an opinion as to the enforceability of the financing statement is often requested and given. This opinion requires review of the UCC Financing Statement and application of the Delaware Uniform Commercial Code — Secured Transactions, 6 *Del. C.* §§ 9-101 et seq.

EXAMPLE:

Insofar as Article 9 of the Uniform Commercial Code as in effect in the State of Delaware on the date hereof (the "Delaware UCC") is applicable (without regard to conflict of laws principles), upon the filing of each Financing Statement with the Division, the Lender will have a perfected security interest in each Borrower's rights in that portion of the collateral (as defined in the applicable Deed of Trust, Security Agreement and Fixture Filing, hereinafter the "Agreement") described in the Financing Statement that may be perfected by the filing of a UCC financing statement with the Division (the "Filing Collateral") and the proceeds (as defined in Section 9-102 (a)(64) of the Delaware UCC) thereof

The UCC opinion expressed above is limited to the State of Delaware and is subject to a number of additional assumptions, qualifications, limitations and exceptions, including the following: (1) that Borrower has sufficient rights to the Filing Collateral and has received sufficient value and consideration in connection with the security interest granted; and (2) that each applicable security agreement and financing statement reasonably identifies the filing collateral.

The Enforceability of Entity Documents Opinion

An opinion is sometimes requested regarding the enforceability of the entity documents against the member.

EXAMPLE:

The respective Limited Liability Company Agreement of each Delaware Entity constitutes a legal, valid and binding agreement of the respective Member of such Delaware Entity, and is enforceable against such Member, in accordance with its term.

The opinion rendered applies only to Delaware law, which grants wide deference to freedom of contract. In essence, the Entity Documents are enforceable as long as adherence to them would not violate the entity's organizational documents and they do not incorporate provisions that are illegal or would be void for public policy. The opinions are generally qualified and limited (see below). Delaware counsel do not opine as to their enforceability under the laws of other

⁶⁸ 12 *Del. C.* § 3806(a).

jurisdictions.⁶⁹

The Authority to File Bankruptcy Opinion.

A frequent issue on which Delaware attorneys are asked to opine is which law determines who can cause an LLC to file bankruptcy.⁷⁰ The Delaware LLC Act and the Bankruptcy Code are silent on this issue. This issue generally requires a separate reasoned opinion.

EXAMPLE:

We believe that a federal bankruptcy court would hold that Delaware law, and not federal law, governs the determination of what persons or entities have authority to file a voluntary bankruptcy petition on behalf of each of the Delaware Entities.

The authority to file bankruptcy opinion letters include lengthy reasoning and analogies to corporations.⁷¹ Based on that reasoning, the authority to file bankruptcy opinion letters generally conclude that state law (Delaware law for Delaware LLCs) governs who has authority to file for bankruptcy on behalf of an LLC. Under Delaware law, the limited liability company agreement's terms determine the identity of the parties having such authority. If the limited liability company agreement is silent on the issue, the decision is left in the hands of the managers (or, if there are no managers, to the members themselves).

The Non-Consolidation Opinion

Substantive non-consolidation or “non-con” opinions are closely related to the authority to file bankruptcy opinion but are based on federal bankruptcy law and not Delaware law. Thus, these opinions are not unique to Delaware counsel but Delaware counsel is frequently asked to provide such opinion letters separate and apart from the Delaware

⁶⁹ While enforceable, some provisions in the governing instrument of a DST may result in the loss of the DST’s ability to take advantage of a tax-deferred exchange under 26 U.S.C. § 1031. For example, 1031 status will likely be lost if the governing instrument authorizes the trustee to: (1) engage in activities other than the collection and distribution of income; (2) exchange the property; (3) accept additional contributions of assets; (4) purchase assets other than short-term obligations that mature before the next distribution date (which are held until their maturity); (5) renegotiate the terms of the debt used to acquire the property; (6) renegotiate existing leases or enter into leases with other tenants (except in the case of the current tenant’s bankruptcy or insolvency); and (7) make other than minor non-structural modifications to the property not required by law. Rev. Rul. 2004-86; 2004-2 CB 191.

⁷⁰ These opinions are generally not requested with respect to other entity types.

⁷¹ See, e.g., *In re Avalon Hotel Partners, LLC*, 302 B.R. 377 (Bankr. D. Oregon 2003) cited with approval in *In re Real Homes, LLC*, 2005 WL 4705262 (Bankr. D. Idaho) and *In re A-Z Electronics, LLC*, 2006 WL 2536298 (Bankr. D. Idaho). See also 2 Collier on Bankruptcy at 11301.04[7][c] at 301-13.

law opinion.

A plan for reorganization under Chapter 11 may substantively consolidate the debtor with some or all of its affiliated entities, e.g., member, manager, leasing company, etc., in order to make the assets of the consolidated entities available to satisfy all creditor claims.⁷² Typically the assets and liabilities of subsidiaries are consolidated into the parent for purposes of valuing and satisfying creditor claims. Such plans are the antithesis of the SPE provisions. While consolidation is rarely imposed because of its extreme impact on creditor's rights and recoveries, when imposed it can have significant impact on a creditor's rights.

Cases imposing consolidation have generated varying criteria among the circuits. Because proper venue for a bankruptcy filing could lie in the domicile of the entity, the location of the secured property or the location of one of the affiliates, the applicable test cannot be certain. Several rationales have developed.

The Second Circuit test considers (i) whether creditors dealt with the entities as a single economic unit and did not rely on their separate entity in extending credit and (ii) whether the affairs of the debtors were so entangled that consolidation will benefit all creditors. *Union Savings Bank v. Augie/Restivo Baking Co. Ltd. (In re Augie/Restivo Baking Co., Ltd.)*, 860 F.2d 515, 518 (2d Cir. 1988). By contrast, the DC Circuit test looks instead at whether the debtors had "substantial identity" and whether the "demonstrated benefits of consolidation heavily outweigh the harm". *Drabkin v. Midland-Ross Corp. (In re Auto-Train Corp.)*, 810 F.2d 270, 276 (D.C. Cir. 1987).

In 2005, the Third Circuit held that the party seeking consolidation must prove either that pre-petition the entities had "disregarded separateness so significantly ... [that] ... their creditors relied on the breakdown of entity borders and treated them as one entity" or that post-petition, "their assets are so scrambled that separating them is prohibitive and hurts all creditors". *In re Owens Corning*, 419 F.3d 195, 211 (3rd Cir. 2005).

Regardless of the test, consolidation is an equitable remedy and as such each case turns on its own facts. The non-consolidation opinion requires careful review of all entity and loan documents, including consideration of any guaranties or indemnities by any affiliates, to be certain that the entities have taken no action that would suggest a disregard of the separateness of the parties or that the lender in some way was relying on the collective credit of all entities rather than each entity on its own.

Opinions Required by Foreign Governments

Many Delaware business entities are owned, either wholly or in part, by individuals or entities residing or organized in other countries. Foreign governments and quasi-governmental entities often request opinions as to the legal effect of corporate actions or organization. Such opinions are often required by tax, banking

⁷² See, e.g., *In re Augie/Restivo Baking Ltd.*, 860 F.2d 515 (2d Cir. 1988); *In re Owens Corning*, 419 F.3d 195 (3d Cir. 2005).

or securities regulatory authorities either on a regular basis or as a consequence of specific action or anticipated action by the foreign owner.⁷³

Because the specific opinions required vary widely depending on the country involved, it is impossible to generalize about the scope of such opinions. However, some items typically requested include:

- Due incorporation/formation and good standing of the Delaware entity.
- Capacity of the Delaware entity to own assets and govern its affairs.
- The legal effect of corporate action such as the appointment of managers, directors and officers or issuance of shares of stock or other ownership interest.
- The legality under Delaware law of disclosures made by the foreign national to the government authority.
- Details as to the ownership structure of the Delaware entity.
- Enforceability of the Delaware entity's operating agreement, bylaws or governing instrument.

Such opinions typically include many of the standard limitations and assumptions discussed in more detail below.

Limitations, Assumptions and Qualifications in Delaware Opinions

No Independent Investigation

The Delaware opinion generally does not rely on independent factual investigation. It is generally limited to the documents provided, and the statements and information set forth therein, all of which are generally assumed to be true, complete and accurate in all material respects.

With respect to all documents examined it is generally assumed that (1) all documents are executed by all necessary parties; (2) all signatures on documents are genuine; (3) all documents submitted as originals are authentic, and (4) all documents submitted as copies conform to the originals of those documents.

Enforceability of Loan Documents Governed by Non-Delaware Law

The Loan Documents generally concern non-Delaware real estate and their enforceability is subject to the laws of other jurisdictions of which Delaware counsel lacks expertise. Any opinion by Delaware counsel regarding the enforceability of the Loan Documents must be limited to such enforceability under Delaware law. As with the Entity Documents, the Loan Documents are generally enforceable under Delaware law unless they require the entity to commit some illegal act.

⁷³ The authors have been called upon to give opinions to government and quasi government authorities of countries and territories including Canada, Cyprus, Ireland, the Isle of Man, Israel, Norway (specifically, DNB Bank ASA in its capacity as registrar/transfer agent for the *Verdipapirsentralen*), South Korea, Spain, and Taiwan.

Execution by Borrower

Delaware counsel generally has no ability to determine that the individual purporting to execute the entity or loan documents actually signed them. The opinion, therefore generally does not express any opinion of due execution by the individual unless the opinion giver has knowledge about the signer and the signature, but rather assumes that the documents were executed by the parties purporting to sign them. In the rare instances where a lender demands that Delaware counsel opine as to the execution of documents, Delaware counsel will only do so upon receiving a certificate from the members, trustees or directors of the entity. In such a case the opinion will extend only as far as the certificate itself and Delaware counsel will undertake no independent investigation.

Limited to Current Delaware Law

The Delaware opinions are limited to the laws (currently in effect) of the State of Delaware (excluding the securities and blue sky laws of the State of Delaware), and expresses no opinion on the laws of any other jurisdiction, including federal bankruptcy and other federal laws and rules and regulations relating thereto. The Delaware opinions are rendered as of the date of the opinion letter. The opinion giver generally undertakes no responsibility to advise anyone of changes in law or fact thereafter occurring.

Opinion Assumptions as to Other Parties

With respect to parties other than Delaware entities to the documents the following is assumed: (1) the due organization, due formation or due creation, as the case may be, and valid existence in good standing of each party under the laws of the jurisdiction governing its organization, formation or creation; (2) the legal capacity of natural persons who are signatories to the documents; (3) the power and authority of each of the parties to execute and deliver, and to perform its obligations under, such documents; (4) the due authorization, execution and delivery by all parties thereto, and (5) that each of the documents constitutes a valid and binding agreement of the parties thereto, and is enforceable against the parties thereto, in accordance with its terms.

Opinion Qualifications as to Enforceability of Rights and Remedies

The Delaware opinions are generally qualified as to the enforceability of the rights and remedies created by the documents being subject to bankruptcy, insolvency, reorganization, moratorium, fraudulent transfer and similar laws of general application from time to time in effect, affecting the rights and remedies of creditors or secured parties, as well as general principles of equity or the exercise of judicial discretion (whether asserted in an action at law or in equity).

Who can rely on the Opinion.

Finally, the Delaware opinion letter should identify who can rely on the letter. Generally in loan transactions, opinions are given solely for the benefit of the

lender, the underwriter that issues a rating on any securities issued in connection with the loan and their respective counsel.

4817-2867-5347, v. 3