

Legal Risk Management Tip
February 2015

SERIES LLCs: POSSIBILITIES AND PITFALLS

Limited liability companies, or LLCs, are a commonly used form of business entity. LLCs are entities created pursuant to state law that allow their owners to mix and match characteristics of corporations, limited partnerships, general partnerships and, in the case of single-member LLCs, sole proprietorships. These flexible entities combine the pass-through taxation of a partnership¹ with the limited liability of a corporation. Since the first limited liability company act was enacted in Wyoming in 1977, all 50 states have limited liability company statutes on the books, and the use of LLCs in certain business settings has become ubiquitous.

In 1996, Delaware adopted the first “series LLC” statute which introduced a new layer of complexity and opportunity to the LLC business form. Series LLCs are a sophisticated form of business entity that are relatively new, and although they present unique and interesting business structuring opportunities, the law surrounding them is still developing. How the series LLC would be treated in certain instances is not entirely clear. Series LLCs are formed pursuant to state law. For ease of discussion, this article focuses on Delaware² series LLC law with some state variations noted.

Overview

The concept behind a series LLC is that a single master or umbrella LLC may be formed, and within that master LLC separate “series” or “cells” can be created. Each series within the master LLC may have different assets, economic structures, members and managers than the other series in the master LLC. Each series also has its own profits, losses and liabilities that are separate and distinct from those of the master LLC or other series within the master LLC. The series LLC can be thought of as roughly analogous to a holding company/subsidiary structure, but since the entire structure is viewed as one entity for purposes of corporate maintenance, the series LLC can be less costly and easier to maintain than a multi-entity holding company/subsidiary structure.

Series LLC Formation

Under the Delaware series LLC law, series can be created within an LLC if (a) its limited liability company operating agreement provides for the establishment of one or more series, (b) separate and distinct records are maintained for each series and its assets are accounted for separately from the master LLC or any other series in the master LLC (which also must be provided for in the operating agreement) and (c) its certificate of formation provides notice that the LLC will have separate series with limited liability among them. If those conditions are met, the Delaware series LLC law provides that:

¹ Although many, if not most, LLCs are taxed as partnerships, an LLC can also elect to be taxed as a “C” corporation or an “S” corporation. In addition, IRS regulations generally regard single-member LLCs as disregarded entities for tax purposes.

² Since Delaware adopted the first series LLC statute in 1996, only a handful of states have adopted similar laws, including Illinois, Iowa, Kansas, Missouri, Montana, Nevada, Oklahoma, Tennessee, Texas and Utah. California, Minnesota, North Dakota and Wisconsin each have series or class concepts in their LLC statutes, but they do not formally provide for the segregation of assets or the liability protections found in the other series LLC statutes.

the debts, liabilities, obligations and expenses incurred, contracted for or otherwise existing with respect to a particular series shall be enforceable against the assets of such series only, and, unless otherwise provided in the limited liability agreement, none of the debts, liabilities, obligations and expenses incurred, contracted for or otherwise existing with respect to the limited liability company generally or any other series thereof shall be enforceable against the assets of such series.³

Once the master LLC has been established, a new series within it can be created by simply amending the master LLC's operating agreement. This process is less expensive and time consuming than organizing a new business. In addition, since the master LLC and its series are regarded as one entity by the state, ongoing maintenance costs would be less than if each series was a separate entity.

It should be noted that the various state series LLC statutes do not describe the series LLC structure as a holding company/subsidiary structure. The master LLC does not necessarily need to be a member of each of its series. Instead, Delaware for example refers to a "member associated with" a series as distinguished from a member "of" a series. Accordingly, it is implied that a member associated with a series is regarded as a member of the master LLC.

Common Uses of Series LLCs

Series LLCs can be utilized in a wide variety of circumstances when a business owner desires to separate business lines. For example, the owner of a manufacturing company may wish to use a series LLC to separate business segments by placing the manufacturing assets and line of business in one series and transportation assets in another series.

Series LLCs have a natural use in the real estate space. Owners of multiple properties typically hold each property in its own separate entity to protect it from the liabilities of the other properties. Holding real estate investments in this manner allows for each transaction to be structured on its own terms, with distinct ownership and financing, economic and governance terms unique to that real estate investment. By utilizing a series LLC, each property can be held in its own series and the owners can retain the asset protection/liability segregation and other benefits of a special purpose entity holding structure while avoiding much of the formation and ongoing operating costs of creating and maintaining numerous entities.

Another application of series LLCs is the private fund space. Hedge fund managers may use series LLCs to segregate assets and create different investment classes to hold side pocket investments and to establish incentive compensation plans that segregate the investments in which different employees are eligible to participate. For example, a series LLC can be utilized to create a fund of funds structure in which a series LLC would contain multiple series, each of which could have its own differentiated investment strategy and would invest only in managers who utilize that particular strategy. This would give investors in the series LLC the opportunity to pick and choose whatever combination of strategies aligns with an investor's investment objectives. Alternatively, each series could have its own underlying manager to give investors the ability to choose from among multiple managers.

Also in the private fund space, series LLCs can be used to efficiently structure a blocker entity for investments by foreign or tax-exempt investors. Such investors often wish to avoid investing in a US partnership for fear of earning income connected with a US trade or business or generating unrelated business taxable income. Funds will typically address this concern by putting such investors in a "blocker" entity that is taxed as a corporation so income is derived through dividends. Rather than forming a separate

³ See Del. Code Ann., tit. 6, §18-215(b).

entity to act as a blocker, the private fund could utilize the series LLC structure to segregate investors into separate series that can each elect to be taxed as a partnership or corporation as needed.

Additional applications of series LLCs include oil and gas transactions and fractions share arrangements as well as uses in estate planning and family gifting so that investments or assets can be segmented and bequeathed or gifted to different individuals.

Uncertainties and Disadvantages of Series LLCs

The benefits and possibilities of series LLCs, as noted above, are numerous; however, they are a relatively new business structure around which law, practice and understanding are still developing. As such, they carry certain risks and uncertainties that should not be ignored when considering whether to utilize this structure. Although a comprehensive list of all uncertainties and disadvantages relating to series LLCs is beyond the scope of this article, some of the more important ones are noted below.

Business Operations

Given that the series LLC is a single entity, an initial uncertainty was whether individual series would be able to effectively operate as individual entities for purposes of contracting and conducting business. In 2007, Delaware revised its laws to clarify that each series within a series LLC has the ability to sue and be sued, to enter into contracts, to hold title to assets and to grant security interests and liens. Even with that clarification, a series LLC falls short of possessing all of the characteristics of a stand-alone legal entity. For example, individual series cannot merge or consolidate with other entities or convert into another type of entity, and since they are not separate and distinct entities, states will not issue good standing certificates for individual series.⁴ Treatment of series in states that do not have series LLC statutes remains an open and developing question.

Tax Treatment

Taxation can be a significant consideration in structuring a business, and unfortunately, the tax treatment of series LLCs remains in some respects an open question. In 2008, the IRS issued a private letter ruling⁵ to a group of insurance carriers who were reorganizing their mutual fund operations into a Delaware series LLC. Implicit in the IRS' ruling was that each series of the master LLC would be treated as a separate and distinct entity for tax purposes. This approach was reinforced by the IRS' release in 2010 of proposed regulations⁶ which would establish separate tax treatment of each series within a series LLC. As a result, each series would be able to "check the box" to elect the desired tax treatment for such series. Although these proposed regulations were never formally adopted, it is prevalent practice to regard the proposed regulations as controlling. It should be noted that the proposed regulations did not provide for recognition of a series as its own taxpayer for all federal tax purposes. For example, the proposed regulations did not address whether the master LLC or the underlying series is the employer for federal tax purposes. In addition, although separate tax treatment of a series implies that series will only be liable for its own taxes, the IRS reserved the right to impose such tax liability on the master LLC or other series under the master LLC. State tax treatment is less clear, with a number of states indicating they will apply to each series its federal tax classification, others indicating a default partnership tax treatment and others who have provided little or no guidance.

⁴ A notable exception to this is Illinois which goes further than Delaware law by providing that "[e]ach series with limited liability may, in its own name, contract, hold title to assets, grant security interests, sue and be sued and otherwise conduct business and exercise the powers of a limited liability company under this Act." See Illinois Compiled Statutes, 805 ILCS 108 §37-40(b). Thus, the series within an Illinois series LLC can merge, consolidate or convert to other entities and the State of Illinois will issue good standing certificates for them.

⁵ See PRL 200803004, Release Date 1/18/2008.

⁶ See Prop. Treas. Reg. §§ 301.3011-6, 301.6071-2 and 301.7701-1(a)(5).

Bankruptcy

The treatment of series LLCs in a bankruptcy context has not been firmly established and fundamental questions such as whether an individual series can file a stand-alone bankruptcy remain open. Speculation among commenters suggests that familiar bankruptcy concepts such as substantive consolidation may provide a framework for analyzing whether the master LLC or other series LLCs under it will be brought into the bankruptcy of a series.⁷ Many factors considered to determine whether substantive consolidation should apply, such as separate ownership of assets and separate accounting, are similar to the preconditions to creating a valid series. Although there is not clarity on these points, a series LLC may be able to take steps to ameliorate the risk that one or more other series will be pulled into a bankruptcy by making the separation and segregation of assets and business lines clear in the respective series' agreements with creditors.

Perception

An additional risk related to series LLCs is one of perception. Many business ventures which may be attracted to the series LLC structure will need to raise capital from third party investors. Many investors are not familiar with series LLCs and a cursory investigation of the business form may yield numerous questions with few concrete answers without highlighting the positive reasons for electing this business form. Also, because of the complex nature of series LLCs, they are vulnerable to scam operators who may be drawn to the ability to mislead investors by doing this such as burying hidden fees and liabilities among the verbiage establishing the series. Accordingly, the lack of understanding and certainty surrounding series LLCs, when added to all of the other risks and uncertainties typically associated with a proposed investment, may render it more difficult to secure investors. Entrepreneurs may ameliorate this risk by acknowledging and explaining the risks and uncertainties to investors and, most critically, having a thoughtful rationale as to how those risks and uncertainties will be effectively managed.

Conclusion

Series LLCs are a new and dynamic business form which provides a number of attractive qualities and opportunities for creative business people. The business form is in its infancy and the "rules of the road" applying to them are still developing. The expectation, however, is that series LLCs are here to stay and that many of their risks and uncertainties will resolve as time marches forward and the use of this business form expands. The business community and the professionals that serve it would be well advised to understand series LLCs and, after due investigation and careful consideration, consider using these entities where they may provide a net advantage.

For more information on these and other considerations, please contact us at (619) 298-2880 or at info@jackolg.com.

Author: Greg Brucia, Esq., Partner; Editor: Robert Conca, Esq., Of Counsel, Jacko Law Group, PC. JLG works extensively with investment advisers, broker-dealers, investment companies, hedge funds, banks and corporate clients on securities and corporate counsel matters.

This article is for information purposes and does not contain or convey legal advice. The information herein should not be relied upon in regard to any particular facts or circumstances without first consulting with a lawyer.

⁷ Substantive consolidation is a bankruptcy concept similar to "piercing the corporate veil" in the corporate litigation context and involves the consolidation of the assets and liabilities of the debtor's bankruptcy estate with the assets and liabilities of another entity or group of entities.