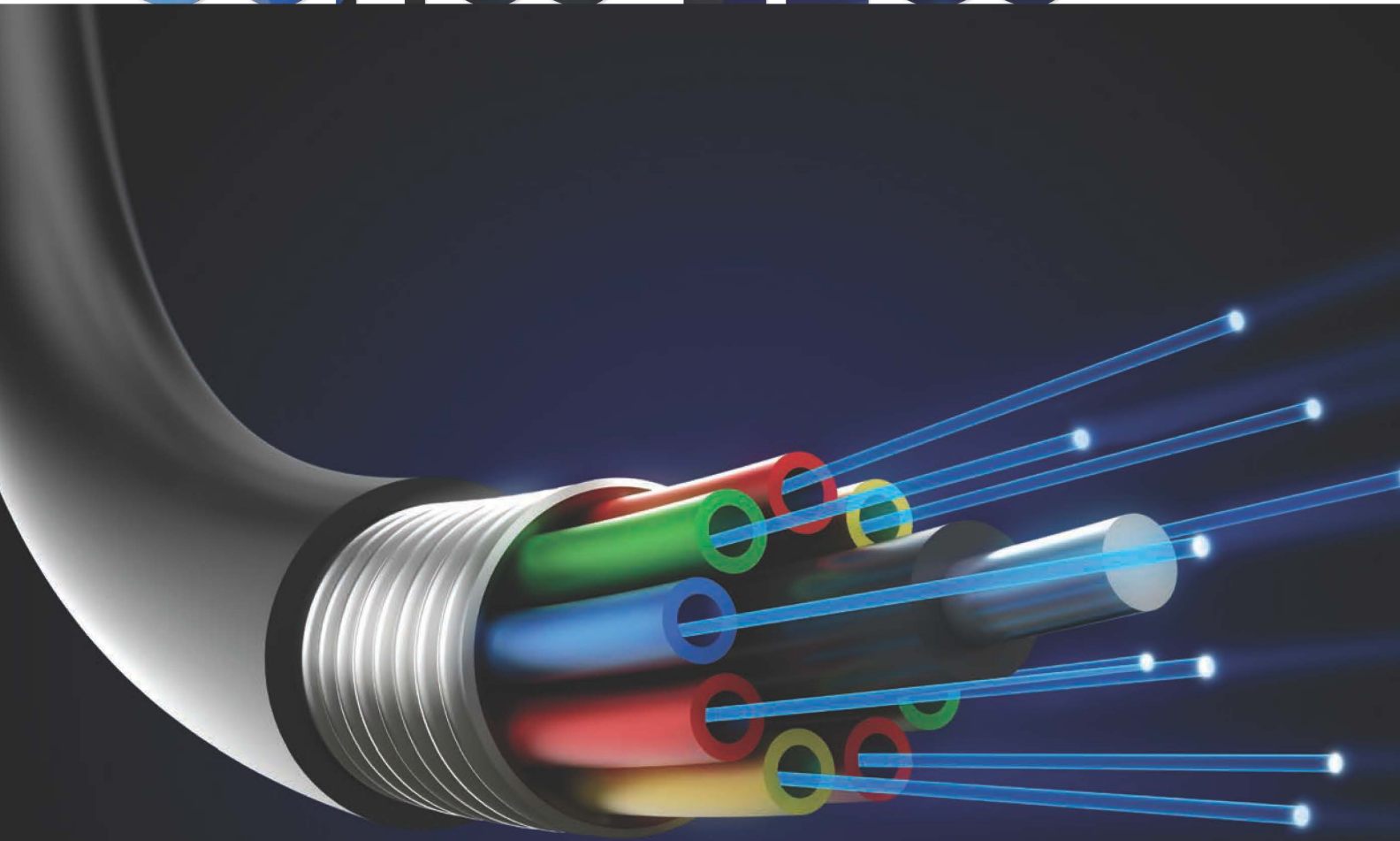


Series LLCs



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Series LLCs are becoming more widely used as a way to operate multiple separate business activities within a single legal entity. Series LLCs have the potential to provide asset protection, but there are limitations and uncertainties surrounding the Series LLC form. This article provides an overview of Series LLCs, highlighting the pros and cons of using this unique form of entity.

Authors



Louis G. Hering
PARTNER
MORRIS, NICHOLS, ARSHT & TUNNELL LLP

Lou is a Partner in the firm's Commercial Law Counseling Group. He practices primarily in the alternative entity and business combination areas with an emphasis on private equity, mutual funds, master limited partnerships, joint ventures and structured finance.



R. Jason Russell
ASSOCIATE
MORRIS, NICHOLS, ARSHT & TUNNELL LLP

Jason is an Associate in the firm's Commercial Law Counseling Group. His practice focuses on the organization of alternative entities and complex transactions involving mergers, asset acquisitions and sales, joint ventures, leasing transactions and financings.

IN 1996, Delaware became the first state to permit the formation of limited liability companies (LLCs) that have multiple series with separate members, managers, LLC interests or assets (Series LLCs). Series LLCs have recently started gaining popularity, and today may be formed in at least eight other states. In Delaware, the number of Series LLCs formed each year has grown from 725 in 2008 to 2,087 in 2011.

Although most commonly used for mutual funds and investment funds, a Series LLC could potentially be used for any type of business when it is desirable to divide the overall business into units with segregated assets and liabilities. Each series of a Series LLC may have characteristics of a separate LLC, such as separate rights, powers or duties with respect to specified property or obligations. Each series may also have its own business purpose or investment objective.

Further, if a Series LLC complies with certain additional requirements of applicable state law, an individual series of the Series LLC will not be liable for the debts, liabilities and obligations of the Series LLC generally or any other series of the group. This type of Series LLC is referred to in this article as a limited liability Series LLC.

This article provides an overview of Series LLCs, focusing on the:

- Flexibility in structuring and organizing a Series LLC.

- Requirements to form a Series LLC and qualify as a limited liability Series LLC.
- Membership, management, distributions and dissolution of an individual series of a Series LLC.
- Primary uses and benefits of Series LLCs.
- Issues and uncertainties surrounding Series LLCs.

This article is based on Delaware law, but highlights certain key differences from other states that permit the formation of Series LLCs.

BUSINESS STRUCTURE FLEXIBILITY

The Series LLC, like an LLC generally, is a flexible entity which drafters can largely structure and organize as they choose under an LLC agreement. For example:

- A Series LLC may have managers, assets and members associated with a particular series that are separate from the managers, assets and members associated with the Series LLC generally and the other individual series.
- A Series LLC may be structured so that each series is managed by the same managers, but the assets and members associated with each series remain separate from those of the Series LLC generally and the other individual series.

- The profits and losses of a particular series may be attributed only to the members associated with that series or to the Series LLC generally.

In certain states, including Delaware, the series form is also available for limited partnerships and statutory or business trusts with characteristics similar to those of Series LLCs.

FORMATION AND QUALIFICATION

To form a Series LLC, a certificate of formation must be filed with the Secretary of State of Delaware. However, the individual series do not have to exist at the time of formation. Under Section 18-215 of the Delaware LLC Act, the LLC agreement

- **Separate records.** On an ongoing basis, the records for any series must account for the assets of that series separately from the assets of the Series LLC itself and any other series of the group. Under Section 18-215 of the Delaware LLC Act, this requirement is deemed satisfied if the records of a series “reasonably identify” its assets. Section 18-215 of the Delaware LLC Act further clarifies that records reasonably identify the assets of a series if the assets are identified by “specific listing, category, type, quantity, computational or allocational formula or procedure (including a percentage or share of any asset or assets) or by any other method where the identity of such assets is objectively determinable.”

A person forming a Series LLC has the same flexibility in structuring membership and management rights and powers associated with each series as they would for separate LLCs.

of the Series LLC must establish one or more series of members, managers, LLC interests or assets of the Series LLC. As is the case with LLCs generally, it is best practice to have a written LLC agreement for a Series LLC, although this is not required in Delaware.

To qualify as a limited liability Series LLC in Delaware, the following three requirements must also be met:

- **Limitation on liability.** The LLC agreement must provide for the limitation on liability. If the Series LLC will have assets or liabilities that will be shared by all series of the Series LLC (for example, certain administrative or management costs), the LLC agreement should explicitly set out the manner in which these assets and liabilities will be allocated among the different series of the Series LLC.
- **Notice.** Notice of the limited liability of each series must be set out in the certificate of formation of the Series LLC. In Delaware (and in most states that permit Series LLCs other than Illinois), a general notice is typically used, stating that:
 - the LLC has or may form series;
 - the liabilities of each series will be enforceable against the assets of that series only and not against the assets of the Series LLC generally or any other series; and
 - unless otherwise provided in the LLC agreement, none of the liabilities existing with respect to the Series LLC generally or any other series will be enforceable against the assets of that series.

If these requirements are satisfied, pursuant to Section 18-215 of the Delaware LLC Act, the debts, liabilities, obligations and expenses of a series will be enforceable against the assets of that particular series only and not against the assets of the Series LLC itself or any other series of the group, unless otherwise provided in the LLC agreement.

MEMBERSHIP, MANAGEMENT, DISTRIBUTIONS AND DISSOLUTION

A person forming a Series LLC has the same flexibility in structuring membership and management rights and powers associated with each series as they would for separate LLCs. Distributions may also be made to members on a series-by-series basis. In addition, an individual series may be terminated without dissolving the Series LLC itself.

MEMBERS OF A SERIES

Each series of a Series LLC may have different members or one or more of the same members associated with it. The LLC agreement can set out the rights, powers and duties of the members. The LLC agreement can also provide for separate classes or groups of members associated with any particular series with different voting, distribution or other rights.

For example, investment funds that establish separate mutual funds as individual series may have separate classes of interests offering different fee structures or otherwise varying certain rights and obligations of the investors. Therefore, one class may require a front-end fee whereas another class may not

SERIES LLCs IN STATES OTHER THAN DELAWARE

In 1996, Delaware became the first state to enact Series LLC provisions. At least eight other states have now adopted provisions in their LLC Acts that permit the formation of Series LLCs. These include:

- Illinois.
- Oklahoma.
- Utah.
- Iowa.
- Tennessee.
- Wisconsin.
- Nevada.
- Texas.

The Texas LLC Act treats Series LLCs essentially the same as the Delaware LLC Act. The LLC Acts of Nevada, Oklahoma, Tennessee and Utah are substantially similar to those of Delaware and Texas. The LLC Acts of Illinois, Iowa and Wisconsin differ from Delaware in their respective approaches to limited liability Series LLCs.

RECORDKEEPING REQUIREMENTS

To qualify as a limited liability Series LLC, a Series LLC formed in Nevada, Oklahoma, Tennessee or Utah must maintain "separate and distinct" records concerning each series in addition to accounting for the assets associated with a series separately from the other assets of the Series LLC and any other series of the group. Illinois and Iowa also require separate and distinct records for each series.

Delaware previously required separate and distinct records to be maintained, but eliminated that requirement when it amended the Delaware LLC Act in 2007. Texas also does not require separate and distinct records. In Delaware and Texas, the records of a series must "reasonably identify" its assets (such as specific listing, category, type, quantity, computational or allocational formula or procedure) (see *Formation and Qualification*).

LIMITED LIABILITY SERIES LLCs

Some states have taken different approaches to limited liability Series LLCs. For example, the Wisconsin LLC Act does not

provide for limited liability Series LLCs. Therefore, there is no statutory basis in Wisconsin for protecting the assets of one series of a Series LLC from the liabilities of the other series of the group.

The Illinois and Iowa LLC Acts each explicitly provide that a series that qualifies for limited liability treatment will be treated as a separate legal entity to the extent set out in the organizational documents of the Series LLC. Therefore, a series of an Illinois or Iowa Series LLC may have the power to take certain actions as a separate legal entity under state law that a series formed in another state may not be able to take.

Although not as broad as in Illinois and Iowa, the Series LLC provisions in Delaware and Texas grant the series of a limited liability Series LLC several significant characteristics of separate legal entities. For example, they provide that a series of a limited liability Series LLC has the power to do the following in its own name:

- Contract.
- Hold title to assets.
- Grant liens and security interests.
- Sue and be sued.

Illinois differs from Delaware and other states because it requires a limited liability Series LLC to file a certificate of designation for each series that is to have limited liability. Illinois also requires that the name of each series contain the entire name of the Series LLC with which it is associated and be distinguishable from the names of all other series of the Series LLC. Although Illinois permits series to be separate legal entities, it also provides that the Series LLC and any of its series may consolidate their operations as a single taxpayer if permitted under applicable law or elect to be treated as a single business to qualify to do business in any state.

have a front-end fee but may require a larger minimum investment. Alternatively, a class may be established solely to invest funds from 401(k) plans. Each class, however, would be part of the same series and therefore invest in the same portfolio of securities.

MANAGERS OF A SERIES

Similar to the options in structuring membership, each series of a Series LLC may have different managers or one or more of the same managers. The managers may be divided into separate classes or groups and may have separate rights, powers and duties as provided in the LLC agreement.

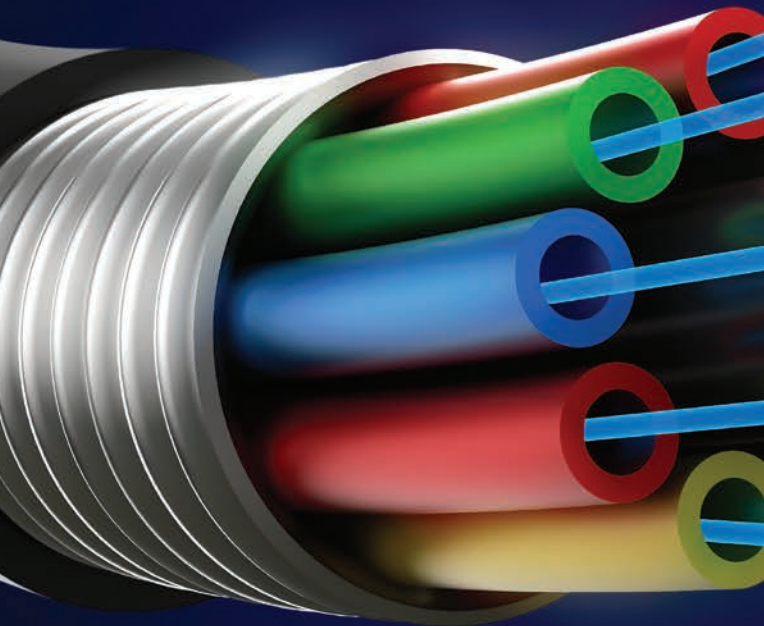
For example, in the mutual fund context, it may be the case that a single board of managers manages all of the series within the Series LLC, although they may appoint separate officers to manage the day-to-day affairs of each series. In Delaware (and the other jurisdictions that have adopted a similar Series LLC statute), if the LLC agreement of a Series LLC does not

indicate how the series will be managed, by default each series will be managed by the members of the Series LLC associated with the particular series.

DISTRIBUTIONS TO MEMBERS

Distributions may be made to members of a Series LLC on a series-by-series basis. In the case of a limited liability Series LLC, the members that are associated with one series may receive distributions from that series whether or not distributions are being (or can be) paid with respect to any other series of the group. Distributions are generally governed by the LLC agreement of a Series LLC. The LLC agreement may provide for distributions with respect to any series at specific times or grant the authority to make determinations regarding distributions to any managers or members associated with the applicable series.

However, Section 18-215(i) of the Delaware LLC Act prohibits a limited liability Series LLC from making distributions to



members associated with a particular series if, after giving effect to the distribution, the liabilities of the series (other than liabilities to members on account of their LLC interests in that series and liabilities for which the recourse of creditors is limited to specified property of that series) exceed the fair value of the assets associated with the series. The fair value of property of the series that is subject to a liability for which the recourse of creditors is limited is included in the assets associated with that series only to the extent that the fair value of that property exceeds that liability.

It is important to note that this Section 18-215(i) test is applied on a series-by-series basis. Therefore, certain series may be able to make distributions while others cannot. Section 18-215(i) appears to permit a distribution that would render a limited liability Series LLC insolvent on a consolidated basis so long as the specific series making the distribution would not be rendered insolvent by the distribution.

DISSOLUTION OF A SERIES

A series of a Series LLC may be terminated and its affairs wound up in any of the following ways:

- As provided in the LLC agreement.
- By a judicial decree.
- Unless otherwise provided in the LLC agreement, by the vote or consent of members associated with the series who own more than two-thirds of the interests in the profits of the particular series.

A series is also terminated upon the dissolution of the Series LLC of which it is a part. However, unless otherwise provided in the LLC agreement, the occurrence of any event that causes a member to cease to be associated with a series does not cause the termination of the series, even if that member is the last remaining member of the series. In addition, subject to Section 18-801 of the Delaware LLC Act, the termination of a series of a Series LLC would not cause the Series LLC to dissolve, unless otherwise provided in the LLC agreement.

The Delaware LLC Act also provides that the termination of a series of a limited liability Series LLC does not affect the limitation on liabilities of the terminated series. As is the case for the dissolution and liquidation of an LLC generally, the persons winding up the affairs of a series are required to distribute the assets to creditors of the series or make reasonable provision for the distribution to creditors before the assets may be distributed to the members associated with the series.

USES AND BENEFITS

As discussed above, the Series LLC form has frequently been used by investment funds, including mutual funds. For example, the sponsor of an investment company may form a Series LLC with each series being a separate mutual fund. In addition, the

Series LLC form can be used for captive insurance companies. This use of a limited liability Series LLC is similar to establishing protected cells for separate assets that may be protected from the liabilities of other protected cells or of the sponsored captive insurance company generally under state insurance laws and regulations.

Under applicable securities laws, a Series LLC may be the sole registrant, but may register interests in all the series of the Series LLC. This can reduce the costs and burdens of filing multiple registration statements.

One of the primary benefits of a Series LLC is that it permits the operation of multiple separate business activities within a single legal entity. Therefore, under applicable securities laws, a Series LLC may be the sole registrant, but may register interests in all the series of the Series LLC. This can reduce the costs and burdens of filing multiple registration statements.

A Series LLC may also permit the reduction of other administrative burdens and costs compared to the alternative of forming multiple LLCs. For example, in Delaware, the state fees to form a Series LLC and the annual tax payable by a Series LLC are the same as those imposed on a non-Series LLC. Therefore, the formation of a single Series LLC can be more cost-efficient than forming and operating multiple LLCs.

However, in determining whether or not to use a Series LLC form, the benefits should be weighed against the limitations and uncertainties associated with Series LLCs. For example, if limiting the liabilities among multiple series is a critical aspect of a proposed transaction, the cost savings obtained by using a limited liability Series LLC rather than forming multiple LLCs may not outweigh the risk that a bankruptcy court may not recognize the limitation on liabilities among separate series (see below *Bankruptcy Proceedings*).

ISSUES AND UNCERTAINTIES

Although the number of Series LLCs being formed in Delaware has steadily increased, the Series LLC remains a relatively

novel entity. There is still significant uncertainty surrounding Series LLCs, in particular relating to:

- The lack of case law.
- Federal and state tax treatment.
- Interstate recognition.
- Bankruptcy proceedings.
- Perfection of security interests.

LIMITED COURT REVIEW

The Series LLC form has not yet been fully tested by the courts. There is one recent case that considered issues relating to a series entity, although it was a Delaware statutory trust. In *Hartsel v. The Vanguard Group, Inc.*, the Delaware Court of Chancery acknowledged the independent nature of a series and held that owners of an equity interest in one series did not have standing to bring claims on behalf of all other series (*Hartsel v. The Vanguard Group, Inc.*, C.A. No. 5394-VCP (Del. Ch. June 15, 2011)).

On the other hand, in *GxG Management LLC v. Young Brothers and Co., Inc.*, which involved a Delaware Series LLC, the US District Court for the District of Maine held that the relationship between a Series LLC and its series “does not create a truly separate legal entity capable of independently pursuing its own legal claims” (*GxG Management LLC v. Young Brothers and Co., Inc.*, C.A. No. 05-162-B-K (D. Me. June 11, 2007 and Feb. 21, 2007)). In its findings, the district court observed that the Delaware LLC Act did not indicate what capacity a series of a Series LLC had to pursue litigation on its own behalf.

In the same year the *GxG Management* case was decided, the Delaware LLC Act was amended to provide specifically that a series of a limited liability Series LLC has the power and capacity to, in its own name, sue and be sued, unless limited by its LLC agreement. This language or similar language appears in the Texas and Illinois LLC Acts, but is not yet included in the LLC Acts of the other states that have enacted Series LLC provisions. Therefore, the issues raised by the court in *GxG Management* may still affect Series LLCs formed under the laws of those states.

TAX TREATMENT

The federal and state tax treatment of Series LLCs is complex and evolving. Because a series of a Series LLC is not considered a separate legal entity under most state laws (other than Illinois and Iowa) and the Internal Revenue Code of 1986, as amended, does not address Series LLCs, there has been some uncertainty concerning their treatment for tax purposes.

Federal Tax Treatment

The Internal Revenue Service (IRS) provided some guidance through a private letter ruling in which it found that series of a Series LLC would be treated as separate entities for federal

taxation purposes. In September 2010, the IRS issued proposed regulations for the treatment of Series LLCs that are consistent with the private letter ruling.

The proposed regulations provide that a series of a Series LLC will be treated for federal income tax purposes as a separate entity formed under local law (with some exceptions, such as employment tax), so long as the local law explicitly permits:

In making a determination as to whether a creditor of one series or of the Series LLC itself could reach the assets of another series, a court could apply veil-piercing principles similar to those applied to find a parent or sister company liable for the liabilities of a subsidiary of the parent.

- The members or participants (for example, officers and directors) of a series to have separate rights, powers or duties with respect to that series.
- A series to have separate rights, powers or duties with respect to specified property or obligations.
- The segregation of assets and liabilities so that none of the debts and liabilities of a Series LLC (other than liabilities to the state in which the Series LLC was formed or relating to the operation of the Series LLC, such as franchise fees) or of any other series of that Series LLC are enforceable against the assets of a particular series of the Series LLC.

Assuming that state law permits a series of a Series LLC to have these attributes, then generally a series is treated as a separate legal entity and determines its tax classification under the “check-the-box” rules. This generally results in a series being treated as a disregarded entity if there is only one member of a Series LLC associated with that series, or a partnership if there are two or more members associated with that series, unless the series elects to be taxed as a corporation.

State Tax Treatment

There is little guidance in most states about the state tax treatment of a series of a Series LLC. There are a few states, however, such as California and Illinois, which have adopted specific rules.

California (which does not permit the formation of Series LLCs) has taken the position that if each series of a Series LLC has certain characteristics, then each series will be treated as a separate entity for state tax purposes. Each series must:

- Have its own members and may be managed separately from the Series LLC and other series of the group.
- Maintain separate books and records.
- Have members that are not financially responsible for its debts and obligations.
- Have its own assets and liabilities.
- Be liable only for its own debts and obligations.

In addition, Illinois provides that a Series LLC and any of its series may consolidate their operations as a single taxpayer if permitted under applicable law or elect to be treated as a single business to qualify to do business in any state. Therefore, under the Illinois LLC Act, a series can individually file as a taxpayer or consolidate with the Series LLC itself and other series of the group.

GENERAL AND INTERSTATE RECOGNITION

Because the limited liability Series LLC form has not been tested by the courts and the majority of states do not permit the formation of Series LLCs, there is a risk that a series would not be recognized and therefore not be protected from the liabilities of the Series LLC itself or other series of the group. In addition, even if the limited liability Series LLC form were recognized, in making a determination as to whether a creditor of one series or of the Series LLC itself could reach the assets of another series, a court could apply veil-piercing principles similar to those applied to find a parent or sister company liable for the liabilities of a subsidiary of the parent.

>> For more information on the doctrine of piercing the corporate veil, search [Piercing the Corporate Veil](#) on our website.

When compared to a parent-subsidiary structure, veil piercing could pose a greater risk to a series of a Series LLC in light of the close relationship among series and the Series LLC. To reduce this risk, a person that forms or manages a limited liability Series LLC should comply with the applicable state statute and follow the appropriate corporate formalities for each series. Examples of corporate formalities include, but are not limited to:

- Having separate bank accounts for each series or keeping detailed records of funds in an account that is attributable to a particular series.

PLC Corporate & Securities has published a number of resources to help counsel form an LLC and draft an LLC agreement. The following resources can be found on practicallaw.com.

>> Simply search the title OR resource number

- ❑ LLC Agreement Commentary or 1-381-0515
- ❑ LLC Agreement: Multi-member, Manager-managed or 3-500-9206
- ❑ Forming an LLC Checklist or 2-381-1369
- ❑ Q&A with Chief Justice Myron T. Steele of the Delaware Supreme Court or 3-515-1049

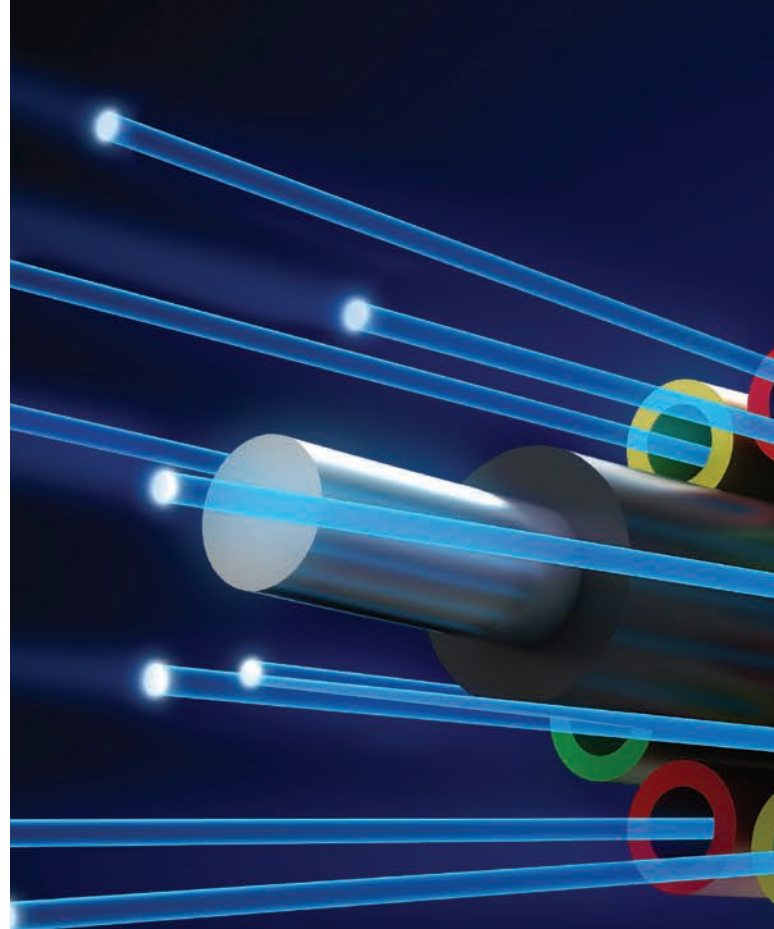
- Indicating in contracts that a particular series is the party to those contracts and not the Series LLC itself or any other series of the group.
- Maintaining minutes and resolutions of the governing members or managers, as applicable, for each series.
- Accounting for the assets and liabilities of each series of the Series LLC separately from the Series LLC itself and any other series of the group.

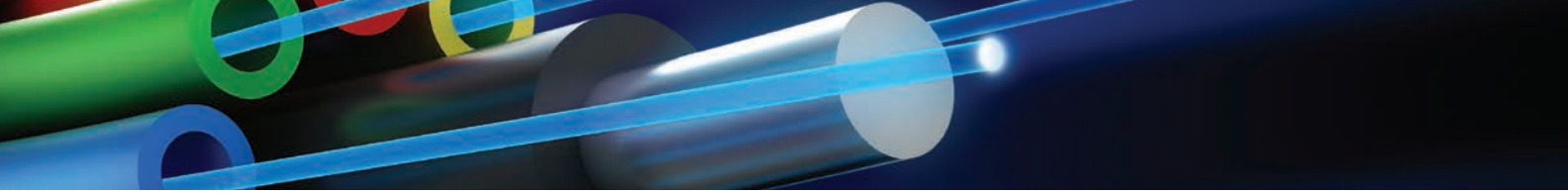
There is a basis under the Full Faith and Credit Clause of the US Constitution for the recognition of the Series LLC form in states that do not have statutes permitting the formation of Series LLCs or show any indication that they will recognize the form. However, it is advisable to engage local counsel in a state in which a Series LLC seeks to transact business for guidance concerning whether the state recognizes Series LLCs and whether there are any filings or other requirements to obtain recognition of the Series LLC. For example, in Delaware, a foreign Series LLC that is filing an application for registration must state, in addition to other information, whether liabilities of a particular series are enforceable against the assets of that series only and not against the assets of the Series LLC itself or any other series.

BANKRUPTCY PROCEEDINGS

The limited liability Series LLC form also has not been tested in the context of a bankruptcy proceeding. In particular, it is unclear whether a series of a limited liability Series LLC may file for bankruptcy in its individual capacity or whether the Series LLC would need to file with all of the other series on behalf of the series that desires to file for bankruptcy.

If a series of a limited liability Series LLC is able to file for bankruptcy in its individual capacity, the assets of the other series of the Series LLC would presumably be protected from creditors of the series that filed. If it is not, the assets of the other series of the Series LLC may be subject to the bankruptcy proceeding. This risk may be lower in states such as Illinois





and Iowa where the series of a limited liability Series LLC are considered separate legal entities for state law purposes. However, this also has not been tested.

In addition, there is concern in the bankruptcy context that the liability protection generally afforded to a series of a limited liability Series LLC may be avoided through the equitable doctrine of substantive consolidation. Under that equitable doctrine, a bankruptcy court may ignore the separateness of a series and treat the Series LLC and each series as a single entity.

To help protect against these risks, as in a parent-subsidiary organizational structure, a person that forms or manages a Series LLC should comply with the applicable state statute and follow appropriate corporate formalities for each series (see above *General and Interstate Recognition*).

SECURITY INTERESTS

There may be significant issues when using a series in secured transactions. It may be unclear whether the debtor is the individual series or the Series LLC. This may turn, at least in part, on whether the Series LLC is formed in a jurisdiction that expressly authorizes a series to hold title to assets and grant liens and security interests. Whether the assets associated with an individual series are actually held in the name of that series or in the name of the Series LLC may be another important factor.

The Uniform Commercial Code (UCC) contains choice of law rules to determine where a financing statement should be filed to perfect a security interest in assets. These UCC rules depend on the type and location of the debtor. If the assets in question are held by the Series LLC on behalf of its series, then it would seem that the Series LLC would be the debtor. Because an LLC is a “registered organization” under Article 9 of the UCC, the rules governing perfection of security interests granted by a registered organization would presumably apply.

However, if the individual series is the debtor, the analysis becomes more complicated. In all of the states in which a Series LLC may be formed (other than Illinois), no filing must be made or maintained showing that the series has been organized. Therefore, at least in these states, a series would likely not be considered a registered organization. If this is the case, then the proper place to file a financing statement is not the state of formation of the Series LLC, but rather depends on the location of the place of business of the series or, if it has more than one place of business, then its chief executive office. The rules on filing financing statements against organizations that are not registered organizations can introduce uncertainty as to the proper place to file.

In addition, if a court were to conclude that the individual series is not the actual debtor, despite the provisions of the applicable LLC Act, the LLC agreement and the security

documents, it is possible that the court could find that only a filing in the jurisdiction of formation of the Series LLC would be effective to perfect a security interest in assets that can be perfected by filing.

Therefore, when taking a security interest in property associated with a series of a Series LLC, the secured party should take all steps necessary to perfect its security interest both as if the Series LLC were the debtor as a registered organization and as if the individual series were the debtor as an organization that is not a registered organization. Although filing in this manner should be effective since it contemplates both scenarios, it illustrates the uncertainties involved in using the Series LLC structure in a secured transaction.