

THE UNCERTAINTIES OF SERIES LLCs

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Although a series LLC seems like an ideal asset protection device for business founders, lingering legal uncertainties have impeded the growth of the series structure as an entity of choice. This article presents some of the key considerations that every lawyer should raise in discussions with a client who has expressed an interest in forming a series LLC.

Nevada is one of 14 jurisdictions in the United States that have adopted statutes providing for the formation of series limited liability companies.¹ These entities are rarely used by business founders as a result of the lack of clear legislative, regulatory and judicial guidance. The IRS, however, published proposed regulations in September 2010 that answered many questions about the federal tax treatment of the series LLC.² Although proposed regulations are not law, they do indicate the IRS's thinking as to their subject matter and taxpayers will generally be deemed to have acted reasonably in relying upon them. Still, it is likely that the finalization of these regulations will serve as a catalyst for enactment of series LLC statutes in some of jurisdictions that have not yet adopted the series LLC concept.³ Other jurisdictions may continue to drag their feet even as other uncertainties relating to the treatment of series LLCs are resolved. Many clients will inquire about using series LLCs for their businesses and it is important that lawyers properly advise them of the benefits and the risks of the series LLC structure.

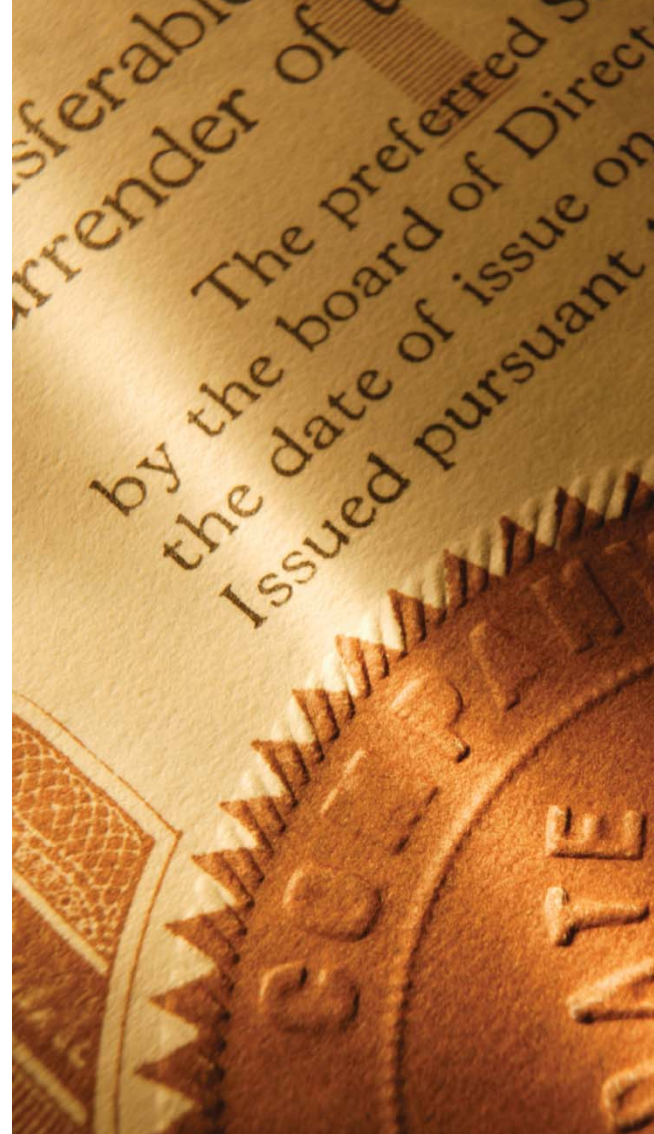
What is a Series LLC?

A series LLC is a limited liability company with internal cells or divisions, each of which may have separate members, managers, assets and liabilities, business purposes or investment objectives.⁴ The assets of each division, or series, are shielded from the liabilities of the other divisions and the LLC itself. The series concept is useful because it allows for the formation of a single legal entity that is composed of separate and distinct asset portfolios with different ownership and management structures.

Nevada Series LLC Requirements and Characteristics

A properly organized and operated Nevada series LLC is a product of careful drafting and observance of formalities. If an LLC is to have one or more series and one or more internal liability shields, then the articles of organization for the LLC must contain:

- i. A statement to that effect; and



- ii. A statement setting forth the relative rights, powers and duties of the series or an indication that such rights will be set forth in the operating agreement or established as provided in the operating agreement.⁵

The articles or operating agreement may create one or more series, or grant authority to one or more members, managers or other persons to create one or more series.⁶ A series may have rights senior to other series, separate powers, rights or duties with respect to specified property or LLC obligations or profits and losses related to such property or obligations, and may have a separate business purpose or investment objective.⁷ The doctrine of limited internal liability provides that the debts, liabilities, obligations and expenses relating to a particular series (whether contractual or tortious) are enforceable against the assets of that series only, and not against the assets of the LLC or any other series if (i) the articles contain the required statement and (ii) separate and distinct records are maintained for the series and the assets of the series are held and accounted for separately from the other assets of the LLC and any other series.⁸ Notably, however, a series is not a separate entity under Nevada law.⁹



Benefits of the Series LLC

The series LLC concept is well-suited in various contexts, including real estate development and management, and trust and estate planning. The internal liability shield allows management to segregate assets into multiple series and thereby limit the exposure of assets for the liabilities associated with other series. The series LLC structure, moreover, allows founders to select which members and managers to associate with any given series.

Because the various series are organized under a single master LLC, management will realize savings in filing fees and paperwork. In Nevada, this means that management is only required to file one set of articles of organization, and obtain one state business license, which will be renewed on an annual basis. The filing savings may appear modest at first glance, but the amount and degree of the savings may become relatively large in an enterprise with numerous series.¹⁰

Risks Associated with the Series LLC

Little guidance existed on the issue of federal tax treatment of the series LLC before the issuance of the proposed regulation in September 2010. Upon publication of the final rules by the IRS, however, a series will be treated presumptively as an entity under local law and, thus, an entity separate from the LLC and the other series for the purposes of federal tax law. As a consequence, depending on the number of members associated with each series, the series may be treated as a partnership (if there are multiple members) or an entity disregarded from its owner (if there is a single member), or, regardless of the number of its deemed members, elect to be treated as a corporation or an “S” corporation. The proposed regulations, however, do not address various issues, including:

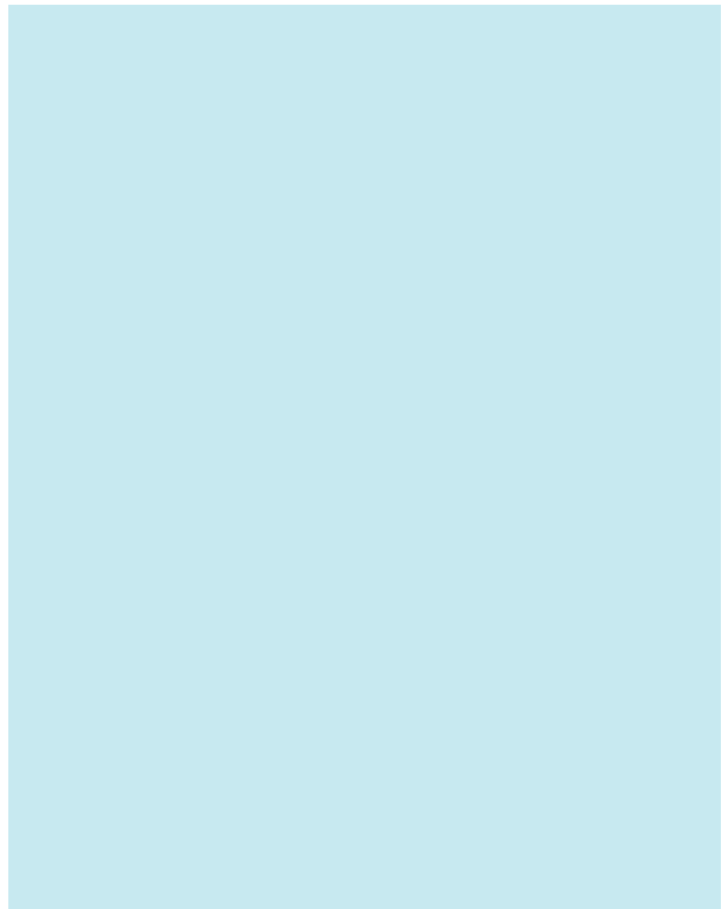
- i. Whether the LLC itself is recognized as a separate entity for tax purposes if it has no assets and engages in no activities;
- ii. How a series should be treated for federal employment tax purposes; and
- iii. Whether an LLC with multiple series may be treated as a single partnership for federal tax purposes under circumstances where there is great commonality of ownership among the series.

Aside from tax issues, the series LLC governing documents must be carefully drafted to follow the specific statutory requirements and, more generally, to

ensure the proper segregation of assets and, in instances involving multiple members, proper association of the members and managers with a particular series. Attention must be given, furthermore, to ensuring that transaction documents are prepared in a manner that clearly identifies the series to be obligated and the authority of the managers and members that are acting on behalf of the particular series to be bound. First and foremost, the failure to comply with the statutory drafting requirements will likely expose the assets of one or more series to the liabilities of other series. Second, a member or manager may be associated with some, but not all of the series. If this is the case, then care must be taken at the formation and operational stages to ensure that any member or manager purporting to act on behalf of the LLC in connection with a particular series (i) has authority to act on behalf of the series, and (ii) does not inadvertently expose the assets or the members or managers of any other series to any third parties. Third, as always, sloppy documentation and a failure to respect formalities will subject managers, members and assets to increased exposure for direct liability under the alter ego theory.

Founders must consider the risk of potential litigation in jurisdictions that do not expressly recognize series LLC and the related internal liability shield. Under the “internal affairs” doctrine, although it is commonly understood that the law of the state of organization will control the resolution of *internal* disputes among members and the LLC, the application of this principle does not present conclusive guidance on the outcome of a dispute between the members of a series LLC and third-party suppliers and creditors, who may be domiciled in a jurisdiction that does not recognize series LLCs. As such, if a Nevada series LLC operates outside of

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Nevada, especially in a jurisdiction without a series LLC statute, it is possible that the courts in such other jurisdictions may not respect the separate existence of the different series.

The status of a series in bankruptcy is unknown. For example, it is not clear whether a series is a “person” with the related right to file a bankruptcy petition that is separate and apart from the LLC and the other series. Even if a series is deemed to have the right to file for bankruptcy on its own, it remains to be seen how the courts will apply the principles of “substantive consolidation” to the series LLC.¹¹

Founders and legal counsel must also consider how the series LLC will be identified in transactions that are intended to be made on behalf of a particular series. This issue presents itself in various contexts. For example, in real estate transactions, how will the property be titled on the deed? Will the title company and the lender accept the titling of property in the name of a series? With respect to secured financing transactions that are governed by Article 9 of the Uniform Commercial Code, what is the proper identification of the debtor on a financing statement? Should management seek to engage in transactions with a counterparty that is unfamiliar with the series LLC concept, management should be prepared to address these issues. And, of course, dealing with such issues only increases the cost of a transaction. In many cases, the additional costs and expenses of dealing with the complexities that arise from the series structure will exceed the cost savings of the reduced series LLC filing fees. As such, it may actually be less expensive to use multiple LLCs rather than a series LLC for the transaction.

Although an exhaustive discussion of the pros and cons of the series LLC concept is beyond the scope of this article, the foregoing discussion is presented as an issue-spotter and a primer to facilitate discussions between attorneys and their clients. With the involvement of competent counsel, a well-advised client will be afforded the opportunity to decide whether the series LLC is the appropriate structure for the client’s business. ■

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1 Eleven jurisdictions, including Nevada, provide for series LLCs with internal liability shields: Delaware. 6 Del. Code § 18-215 (2012); District of Columbia. D.C. Code § 29-802.06 (2012); Illinois. 805 ILCS 180/37-40 (2012); Iowa. Iowa Code Ann. § 489.1201 (2012); Kansas. 2012 Kan. ALS 50 (approved March 29, 2012) (amending K.S. § 17-7663 (2012)); Oklahoma. 18 Okla. Stat. § 18-2054.4B (2012); Puerto Rico. 14 L.P.R. § 3967 (2012); Tennessee. Tenn. Code § 48-249-309 (2012); Texas. Tex. Bus. Org. Code § 101.601 (2012); and Utah. Utah Code §§ 48-3-1201 – 1210 (2012). The three jurisdictions provide for series LLCs without internal liability shields: Minnesota. Minn. Stat. § 322 B.03 (2012); North Dakota. N.D.C.C. § 10-32-02.55 (2012); Wisconsin. Wis. Stat. § 183.0504 (2012).

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- 2 The IRS has not finalized its rulemaking as of November 1, 2012, although the authors were informed unofficially by an IRS staff member that the final action remains on the agenda for 2012.
- 3 The history of LLCs is perhaps instructive on this point. Only two jurisdictions (Wyoming and Florida) had adopted statutes providing for the formation of LLCs before the IRS issued its classification ruling in 1988.
- 4 NRS Section 86.1255 defines “series” as a “series of members’ interests having separate rights, powers or duties with respect to property, obligations or profits and losses associated with property or obligations, which are specified in the articles of organization or operating agreement or specified by one or more members or managers or other persons as provided in the articles of organization or operating agreement.”
- 5 NRS 86.161(1)(e).
- 6 NRS 86.296(2).
- 7 *Id.*
- 8 NRS 86.296(3).
- 9 The creation of a series is accomplished pursuant to the operating agreement and without any filings with the Nevada Secretary of State. The Secretary of State, therefore, cannot issue a certificate of good standing for a series.
- 10 The cost of organizing an LLC is \$400 in initial state filing and license fees and \$325 each year thereafter, plus the related expedited filing and registered agent fees for the entity. See Nevada Secretary of State Fee Schedule-LLC, Rev. 2/11/14 (available at <http://nvsos.gov>) (last visited Oct. 29, 2012).
- 11 See, e.g., *In re Meruelo Maddux Props., Inc.*, 667 F.3d 1072, 1075 (9th Cir. 2012).



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