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## The series limited liability company: Innovative, flexible ... and complicated

### Abstract

Since the introduction of the limited liability company (LLC) in the United States of America, various states have recognised the need to experiment with ways of improving the limited liability this structure offers. Of particular interest in this regard is the development of the series LLC. The series LLC was intended to provide a more flexible manner for businesses to conduct their activities, while preventing the risks of liability from affecting the entire LLC enterprise. However, uptake of the series LLC has been slow. This can allegedly be ascribed to uncertainty about how this structure may be utilised for commercial purposes, as its relation to business law remains, to a large extent, unresolved. This article examines these uncertainties, including the “separateness” of the series LLC, the recognition of the limited liability it affords, the application of bankruptcy law, taxation, as well as the fiduciary duties attached to the structure. Certain recommendations are made to ease the way forward, while further legal development is awaited. First, series LLC statutes need to specifically provide for all the rights of each series as well as the rights reserved for the master LLC. Secondly, these statutes must specify a default rule for the measure of “separateness” between the master LLC and each series. Finally, series statutes ought to provide for notice of the limited liability of each series to creditors of the LLC.

### Die aanspreeklikheidsbeperkte maatskappygroep: Innoverend, buigsaam ... en ingewikkeld

Sedert die bekendstelling van die aanspreeklikheidsbeperkte maatskappy (LLC) in die Verenigde State van Amerika het verskeie state die behoefte erken om te eksperimenteer met maniere om die beperkte aanspreeklikheid van hierdie struktuur verder te verbeter. 'n Besonder belangrike ontwikkeling in dié verband is die aanspreeklikheidsbeperkte maatskappygroep, of die LLC-groep. Die LLC-groep is bedoel om 'n buigsamer manier te bied waarop ondernemings hul bedrywighede kan onderneem, en terselfdertyd te keer dat die risiko's van aanspreeklikheid die hele LLC-onderneming raak. Tog word die LLC-groep nog weinig gebruik. Dit kan vermoedelik toegeskryf word aan onsekerheid oor hoe hierdie struktuur vir kommersiële doeleindes gebruik kan word, aangesien die ondernemingsregtelike standpunt daarvoor nog merendeels onduidelik is. Hierdie artikel ondersoek hierdie onsekerhede, onder meer die “afsonderlikheid” van die LLC-groep, die erkenning van die beperkte aanspreeklikheid wat dit bied, die toepassing van die

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reg van bankrotskap, belasting sowel as die vertrouensverpligtinge wat met dié struktuur gepaardgaan. Sekere aanbevelings word gedoen om die pad vorentoe te vergemaklik terwyl daar op verdere regsontwikkelings gewag word. Eerstens sal wette oor LLC-groepe bepaald voorsiening moet maak vir al die regte van elke groep, sowel as die regte wat vir die hoof-LLC voorbehou word. Tweedens moet hierdie wette 'n versterkreël bepaal vir die meting van "afsonderlikheid" tussen die hoof-LLC en elke groep. Laastens behoort wette oor LLC-reekse ook voorsiening te maak vir kennisgewing van die beperkte aanspreeklikheid van elke groep aan die krediteure van die LLC.

## 1. Introduction

The limited liability company (LLC) rose from obscurity to a viable, mainstream business option in the United States of America. Entrepreneurs wanting to expand their business, while enjoying the limited liability and tax advantages offered by the limited liability company, needed a more flexible option. A series LLC was introduced to fulfil this business need. The series LLC is a single LLC with numerous series, allowing for each series to have its own assets, members, management, assets, rights, duties and liabilities. Each series is independent and the liabilities of each series are only enforceable against that series. The series LLC structure may roughly be compared with a company group, *i.e.*, the holding company and its subsidiaries.

This article discusses the formation, characteristics and use of the series LLC. The article gives a brief overview of the historical development of the LLC and the series LLC. The article also focuses on the separateness, limited liability as well as the fiduciary duties of the series LLC. The influence of taxation and bankruptcy on the series LLC is also examined.

The emphasis in this article is placed on the development of the LLC in the American corporate legislation as an example of new and modern ideas to ensure active participation of more businesses in the formal sector of the economy. These developments in the American law must be viewed especially in the light of reform of the South African corporate law through the *Companies Act* 2008 that did the exact opposite of the American developments. The South African corporate reform process killed the close corporation and tried to accommodate smaller businesses with public and even listed companies in one *Act*. The American reform went the other way, by introducing the LLC that can accommodate even small partnership-like businesses while allowing the LLCs to be used when these businesses need to expand. The American development can be used as a guideline for future developments of the South African corporate law.

## 2. Historical background and development

Historically, there were only two options in the United States of America for structuring a business entity with two or more owners: a partnership or a corporation.<sup>1</sup> Where a business entity was not incorporated, it was

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1 Chrisman 2010:465.

considered a partnership by default.<sup>2</sup> Although a partnership allowed for flow-through taxation,<sup>3</sup> there was no limited liability for the partners.<sup>4</sup> All partners were personally liable for the legal and economic consequences associated with the business activities of the partnership. A corporation (company), on the other hand, provided for limitation of liability for its members, shareholders and managers,<sup>5</sup> but was subject to double taxation.<sup>6</sup> Thus, neither entity structure seemed beneficial. Prior to the introduction of the LLC, states attempted to introduce the limited partnership in an attempt to ensure limited liability and a better tax structure for businesses.<sup>7</sup> The result was limited liability for partners, but with at least one general partner with unlimited personal liability.<sup>8</sup> Limited partners were also at risk of losing that status if they became too involved in the business.<sup>9</sup> The limited liability was, therefore, only validated by the necessary absence of the limited partners from the business activities of the limited partnership, and was only applicable to such limited partners.

The rationale behind the move to introduce the LLC structure through legislation was to combine the benefits of a partnership and corporation, thereby providing for limited liability protection, while securing the benefits of flow-through taxation.<sup>10</sup> The formation and first statutory recognition of the LLC by the state of Wyoming<sup>11</sup> in 1977 was followed five years later with the adoption of the *Florida Limited Liability Company Act* patterned after the Wyoming statute.<sup>12</sup>

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2 Chrisman 2010:465.

3 The direct passage of profits and losses to members, without being subject to taxation at entity level. See Blake 2010:11.

4 Chrisman 2010:465.

5 Chrisman 2010:465.

6 Double taxation is when income tax is paid twice on the same income source. This applies to corporations, as they are considered to exist as legal entities separate from their shareholders. Accordingly, the income generated by the corporation is taxed, whereafter the dividends paid to its shareholders in respect of the income also incur income tax liability. There is a substantial amount of debate concerning the fairness of the double taxation policy, but the choice afforded to corporations not to pay out dividends to avoid double taxation seems to pre-empt the opposition thereto for the time being. See "double taxation", [http://www.investopedia.com/terms/d/double\\_taxation.asp](http://www.investopedia.com/terms/d/double_taxation.asp) (accessed on 11 August 2013).

7 Chrisman 2010:465.

8 Chrisman 2010:465.

9 Chrisman 2010:465.

10 Chrisman 2010:466.

11 Wyoming Statute section 17-15-113 (1977); Gazur & Goff 1991:389; Steinberg & Conway 1992:1105; Sargent 1992:1072; Geu 1992:45; Kalinka 1992:1084; Goforth 1994:1225; Bryans & Shields 1995:79 note 2; Oesterle 1995:882; Thompson HL 1995:131; Nation 1996:25; Snyman & Henning 1997:675; Beard 2008:9; FitzSimons 2008:20.

12 Geu 1992:45; Kalinka 1992:1084; Gazur & Goff 1991:389; Ginocchi & Taylor 1995:615; Seemann 1983:536.

The predominant concern associated with the LLC was its tax implications, especially since an LLC is structured to encompass elements associated with both a partnership and a corporation. Despite the legal basis provided for by Wyoming state law, the United States Internal Revenue Service was slow to contemplate its treatment of LLCs for taxation purposes. Despite the favourable ruling by the Internal Revenue Service in the matter of the Hamilton Brothers in Revenue Ruling 88-76, allowing them to treat their LLC like a partnership, the tax status of LLCs remained unspecified. This uncertainty surrounding LLC taxation hindered the implementation of the structure across the various states. Under the 1997 tax classifications, an unincorporated entity such as an LLC could be classified as a corporation, a partnership or a trust, depending on whether it possessed corporate characteristics.<sup>13</sup> If the unincorporated entity resembled a corporation more closely than it did a trust or a partnership, the entity was generally regarded as an association, and taxed accordingly.<sup>14</sup> The 1997 tax regulations provided for six definitive characteristics that were to be used to classify an unincorporated entity for taxation purposes, namely the existence of associates, an objective to carry on business and divide gains, continuity of life, centralisation of management, limited liability, and the free transferability of interests. When a comparison was made, the characteristics common to both LLC and partnership were ignored — that of associates and the objective to carry on business and divide gains.<sup>15</sup> Accordingly, the LLC would be classified as a partnership if the entity exhibited any two or more of the four remaining characteristics.<sup>16</sup> Obviously, the LLC also inherently possessed the limited liability<sup>17</sup> characteristic, rendering the application of that characteristic for purposes of tax classification less effective. Thus, the 1977 regulations would classify an unincorporated entity as an LLC only if it exhibited two of the three remaining classification characteristics, namely continuity of life, centralisation of management, and free transferability of interests.<sup>18</sup>

In December 1996, the United States Treasury Department issued regulations under the Internal Revenue Code § 7701 that allowed most entities to indicate how they wished to be taxed by checking the applicable

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13 State law determined whether a particular characteristic was present or not, while federal law assigned the meaning of each characteristic in the classification scheme. See Bishop 2009:464.

14 Bishop 2009:464.

15 Bishop 2009:464.

16 Bishop 2009:464.

17 The standard and extent of limited liability is submitted to vary from state to state and, unless the limited liability was not deemed to be the super-controlling factor in determining the nature of the entity for taxation purposes, the remaining three characteristics would be used. Inevitably, the application of the characteristics will also be subject to the standard for application endorsed under state law. See Bishop 2009:464.

18 Thompson RB 1995:921; Snyman & Henning 1997:677; Haguewood 1998:432-433.

box.<sup>19</sup> The “check-the-box” regulations (or CTB regulations, as they were soon referred to) presented LLC owners with a choice between having their LLC taxed as a partnership or a corporation if certain requirements were met.<sup>20</sup> An entity had to prove<sup>21</sup> that it constituted a “separate entity”<sup>22</sup> or a “business entity”<sup>23</sup> under the Treasury regulations,<sup>24</sup> and not a “per se corporation”,<sup>25</sup> to qualify<sup>26</sup> for using the CTB system.<sup>27</sup> The CTB regulations seemed to provide certainty in respect of both multi-member and single-member LLCs. Initially, and quite obviously, a single-member LLC did not qualify as a partnership<sup>28</sup> for the purposes of taxation, due to the lack of associates.<sup>29</sup> However, the CTB regulations now ensured that a single-member LLC could be taxed as a corporation, or be disregarded as an entity that does not report separately from its owner.<sup>30</sup> With the introduction of the CTB regulations and the subsequent enactment of the *Uniform Limited Liability Company Act*,<sup>31</sup> all 50 states incorporated LLC statutes, which provided for the formation of the single-member LLC.<sup>32</sup> Thus, the issue of LLC taxation was presumably settled.

At present, businesses in the United States of America can comfortably regulate their business activities according to the LLC structure, without much apprehension. Initially slow on the uptake, the LLC has become one of the fastest-growing business structures in America. However, several questions regarding the proposed limited liability afforded to the members of an LLC remained unresolved, including whether courts in non-limited liability states would, in fact, recognise the limited liability status of an LLC, and the extent to which a court would apply the veil-piercing doctrine to an

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19 Mertens 2009:278; Kleinberger 2009:474; FitzSimons 2008:22. If the LLC failed to check a box to indicate its taxation preference, it would be treated as a partnership by default.

20 Chrisman 2010:466; FitzSimons 2008:22.

21 Treasury Regulations § 301.7701-1(a).

22 Determining whether a business is a ‘separate entity’ is difficult, because current series LLC legislation does not provide any definitive framework, according to Mertens 2009:279.

23 A ‘business entity’ is generally any entity that is not a trust, or that is subject to any special federal income tax treatment, according to Mertens 2009:279.

24 Treasury Regulations § 301.7701-2(a), as amended in 2007.

25 It must have filed articles of organisation or the equivalent, and not articles of incorporation, according to Mertens 2009:280.

26 Treasury Regulations § 301.7701-2(b).

27 Mertens 2009:278.

28 See Bishop 2009:469. In the absence of at least two members, or associates, an entity is precluded from being recognised as a partnership, but corporate status is not precluded if the entity aims to conduct business for profit. Thus, such an entity may be classified as either a corporation or a sole proprietorship that conducts business through agency, including its only member.

29 Bishop 2009:469.

30 Blake 2010:11.

31 *Uniform Limited Liability Company Act* (amended 1996), 6A U.L.A. Hereinafter abbreviated as ULLCA.

32 Bishop 2009:469.

LLC.<sup>33</sup> These concerns have generally been resolved by way of state law and the development of the common law.<sup>34</sup>

## 2.1 Enter the series LLC

Various states have recognised the need to experiment with ways of improving the limited liability afforded by an LLC, especially the state of Delaware. Of particular interest is the development of the series LLC, the concept of which is derived from the statutory trust and is akin to the notion of a “cell company”, especially the protected cell company established in locations such as the Cayman Islands, the British Virgin Islands, Belize, Bermuda, Guernsey, and Mauritius.<sup>35</sup> Known as a “segregated accounts company” or “segregated portfolio company”, a cell company is an entity that consists of various “cells”, generally comprising a core cell and various subcells.<sup>36</sup> Each cell is responsible for its own assets and liabilities to the extent that even the core cell can be insulated from the liabilities and insolvency of any of its subcells.<sup>37</sup>

The concept of the Delaware series first arose within the context of the *Delaware Business Act*, now known as the *Statutory Trust Act*.<sup>38</sup> Thus, the notion of the series LLC pertains to the Massachusetts trust, also known as the common-law business trust, which allows for the management, control and operation of certain business activities in a segregated manner.<sup>39</sup> The series LLC is derived from the statutory business trust, which is governed by statutes enacted in the majority of states in response to the legal uncertainty surrounding the common-law trust.<sup>40</sup> A statutory trust must be created and operated in a manner similar to any other business entity with rights and obligations, such as the right to sue and be sued in its own name.<sup>41</sup> In 1990, Delaware enacted legislation codifying the series statutory business trust.<sup>42</sup> The statute used familiar words to describe one or more series of a statutory trust created by the governing instrument, which would limit liability between each series in respect of the debts, liabilities, obligations and expenses incurred.<sup>43</sup> This formed the foundation for the series LLC.

In 1996, the state of Delaware introduced the LLC series provision by adding it to the provisions contained in the *Delaware Limited Liability*

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33 Beard 2008:12.

34 Beard 2008:13.

35 Gattuso 2008:33; Mertens 2009:299; Blake 2010:2.

36 Blake 2010:2.

37 Blake 2010:2.

38 Del. Code. Ann. tit. 12, § 3826 (2012) *Delaware Limited Liability Company Act*; Conaway & Tsoflias 2012:5.

39 Conaway & Tsoflias 2012:5.

40 Mertens 2009:299.

41 Mertens 2009:299.

42 Mertens 2009:299.

43 Mertens 2009:299.

*Company Act 2012*, in terms of which liabilities can be charged to the property located in that particular series only, shielding the other series and the parent entity from any liability. It must also be remembered that the limited partnership is still intact as a potential business structure. Thus, depending on the applicable law, a series LLC may exist within the LLC itself, within a statutory trust, or within a limited partnership.<sup>44</sup>

The intention with the series LLC was to provide a more flexible manner for businesses to conduct their activities, while preventing the risks of liability from affecting the entire LLC enterprise. The structure of a series LLC combines the internal flexibility of various business types and provides unincorporated business organisations with statutory support for “maximum freedom to contract” and “enforceability of agreements”.<sup>45</sup>

Furthermore, the series LLC aims to reduce the administration costs and filing fees associated with the utilisation of multiple LLCs by a single enterprise.<sup>46</sup> The series LLC allows a corporation to place a series of properties or businesses with separate purposes or businesses with separate investments objectives in different entities. The series LLC can thus be utilised instead of forming numerous ordinary LLCs. Each series of the “master” LLC is a separate legal entity and may have different assets, rights, duties, liabilities, members, and a series may be dissolved and wound up, while the other series continue to exist.<sup>47</sup> This enables the “master” LLC to separate assets, liabilities and duties, and create a shield between the different series and, in this way, the assets of one series will be protected from the liabilities of another series.<sup>48</sup> Thus, the segregation of each series LLC from the others isolates them from sharing in, or being subjected to the losses, profits and administration of any of the other series in the LLC. This creates a shield that protects each series LLC from the legal repercussions, including lawsuits, insolvency and the like, facing any other series LLC.<sup>49</sup>

The majority of these statutes are modelled after the Delaware statute, excepting that of the state of Illinois.<sup>50</sup> As yet, the series LLC has not gained much popularity, and by the year 2010, only seven states had adopted series LLC statutes.<sup>51</sup> The slow uptake of the series LLC is alleged to emanate from the uncertainty as to how this structure may be utilised for commercial purposes. The series LLC was originally designed for

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44 Rutledge 2013:69.

45 Rutledge 2013:69; Conaway & Tsoufias 2012:3.

46 The most widely recognised utility is the documentary efficiency that the series LLC provides. In the past, business objectives required the creation of multiple documents; now, multiple LLCs may be achieved with the submission of a single document. These savings are complemented by a reduction in legal, accounting and administration fees in certain instances. See Blake 2010:6.

47 48 Gingerich 2009:185; Ribstein 2008:42; Goforth 2007:387; Gattuso 2008:33.

48 Gingerich 2009:185.

49 Gingerich 2009:185.

50 Gingerich 2009:186.

51 Gingerich 2009:185.

asset securitisation and the organisation of investment companies.<sup>52</sup> In its original form, the series LLC is an “administrative subunit of an investment LLC”.<sup>53</sup> Bahena<sup>54</sup> submits that the legal uncertainties concerning the series LLC’s liability shield would have caused less concern if the structure was applied within the traditional context of utilisation — for its “administrative efficiencies rather than its liability-protection capabilities”. The utilisation of the series LLC is, however, no longer limited to the “traditional” context, but it has subsequently been used in various business ventures.<sup>55</sup>

This move from a purely administrative structure to a regulator of the commercial activities of a business entity has catapulted the series LLC into a new legal dimension, which requires more extensive thought and consideration with regard to the implications of the commission of the series LLC for liability protection.

### 3. Formation of the series LLC

A series LLC is a single LLC that has multiple series, each of which constitutes a miniature LLC.<sup>56</sup> The series LLC can thus be viewed as the “master” LLC, which in itself is a separate entity, with a number of separate LLCs welded together, although functioning distinctly and separately from the “master”.<sup>57</sup> Under series LLC statutes, the series LLC, or the master, is created in much the same manner as a regular LLC, with the filing of articles of organisation (or a certificate of formation).<sup>58</sup> In the case of the series LLC, the filing of only one registration document with the Securities and Exchange Commission will suffice in respect of the organisation of the master series as well as all of its series together.<sup>59</sup> The series LLC is beneficial because of its high potential for administrative cost savings. Unlike the formation of multiple LLCs, a series LLC does not require LLC formation and filing costs to be incurred for each individual series.<sup>60</sup> A series LLC can also minimise annual maintenance, administration and compliance costs.<sup>61</sup> Thus, the series LLC structure offers potential for significant administrative efficiencies and cost savings. However, there are certain lingering uncertainties regarding series LLCs with regard to both tax and non-tax issues.

Despite the uncertainty surrounding the use of the series LLC, it seems to accommodate a variety of business types, the most obvious of which

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52 Bahena 2010:803.

53 Bahena 2010:803.

54 Bahena 2010:803.

55 Bahena 2010:803.

56 Marsico 2006.

57 Marsico 2006.

58 Marsico 2006.

59 Levine & Stahl 2011:3.

60 Levine & Stahl 2011:3.

61 Levine & Stahl 2011:3.

being real estate<sup>62</sup> or any entity that holds corporeal property assets.<sup>63</sup> In the most basic form of the series LLC, the master LLC owns the majority share of each series, while the individual owner of each series has an interest in the parent LLC.<sup>64</sup> A second possible structure resembles a brother-sister relationship, where the LLC exists to create several series, with which it has no further relationship.<sup>65</sup> In this instance, the individual series owners generally have an interest in both the master LLC and each series.<sup>66</sup>

LLC membership interest can be allocated in a very flexible manner, but each allocation must be considered to have a substantial economic effect<sup>67</sup> in respect of the formation and functioning of the LLC.<sup>68</sup> Yet, there is no set requirement for a member to be allocated a share of all profits in the partnership, or to have a direct profit interest in every element of a partnership's activities.<sup>69</sup> Section 701 of the *Delaware Limited Liability Company Act* provides that "[a] member has no interest in specific limited liability property".<sup>70</sup> Therefore, a member's interest in an LLC is "personal property", and is thus an income interest only.<sup>71</sup> Following on this, Conaway and Tsoflias<sup>72</sup> conclude that if a member in an LLC cannot own "property" of the LLC, a member of a series cannot own "property" of a series either.

It must be kept in mind that series LLCs are not governed by free-standing legislation typically associated with corporate and general partnership statutes.<sup>73</sup> The formation of a series LLC takes place in three distinct stages. The first stage entails the allocation of business property into smaller or "separate" units.<sup>74</sup> The second phase requires the establishment of a "link"<sup>75</sup>

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62 Gingerich 2009:188.

63 Many private individuals and corporate entities own multiple properties, which they prefer to keep separate for the purpose of limiting liability that may result from lawsuits or insolvency of the person or entity. The series LLC enables a person or entity to maintain each property under one umbrella (the master LLC), while each series separates each property for liability purposes. See Gingerich 2009:188.

64 Mertens 2009:275.

65 Mertens 2009:275.

66 Mertens 2009:275.

67 The allocations must be based on real economic factors, and not simply be shifted around to affect the owner's income taxes, according to Blake 2010:13.

68 Blake 2010:13.

69 Blake 2010:14.

70 Del. Code. Ann. tit. 6, § 18-701 (2007) *Delaware Limited Liability Company Act*.

71 Del. Code. Ann. tit. 6, § 18-702(a), (b) (2007) *Delaware Limited Liability Company Act*; Conaway & Tsoflias 2012:40.

72 Conaway & Tsoflias 2012:41.

73 Goforth 2007:389. Series LLC statutes are effected by making use of specific provisions that are embedded in existing LLC legislation. Accordingly, most provisions concerning the formation and operation of a series LLC are found in the LLC statute of state, according to Goforth 2007:390.

74 Del. Code. Ann. tit. 6, § 18-215(b) (2007) *Delaware Limited Liability Company Act*; Gattuso 2008:33.

75 This link serves to determine matters concerning voting rights; additional members, managers or series; the dissolution, merger or conversion of a series;

between a member, manager or membership interest and a series for the purpose of receiving profits, losses and distributions and to determine the management rights and duties related to that series.<sup>76</sup> The third and final stage entails ensuring that a limitation on liability of one series in respect of any other is put in place.<sup>77</sup> To achieve the desired limited liability, the certificate of formation<sup>78</sup> of the series entity must refer to notice of the series.<sup>79</sup> Good practice advocates that the certificate of formation should make direct use of the language of the authoritative statute pertaining to the limitation of liability, so as to ensure that there is maximum notice of the existence of a series, and full compliance with the directive for notice of limited liability.<sup>80</sup>

There are two mandatory requirements that must be met in order for a series LLC to be formed. The first requirement for the formation of a series LLC under Delaware law is the inclusion of a “notice of the limitation on liabilities of a series” in the LLC’s certificate of formation.<sup>81</sup> The *Delaware Limited Liability Company Act* does, however, not require any specific information concerning any specific series that an LLC might have, nor does information concerning the assets and operations need to be included in the certificate of formation for the purposes of notification.<sup>82</sup> Subsequently, the LLC may terminate or create any number of series without any additional administration, as no series needs to be specifically referred to or named in the certificate of formation.<sup>83</sup> Unless otherwise provided in the LLC operation agreement, the management of the LLC and its series vests in the members in proportion to their current interests in the profits of the series.<sup>84</sup> Despite the default requirement for independent management and control of each series, the statute provides for the alteration of this provision, without forfeiting limited liability to the parent entity or any of the other series.<sup>85</sup>

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exit rights, etc. Therefore, the second phase involves the central contractual capstone of the series that sets forth all the rights and duties of the persons associated with the series. See Conaway & Tsoflias 2012:33.

76 Del. Code. Ann. tit. 6, § 18-215(e) (2007) *Delaware Limited Liability Company Act*.

77 Conaway & Tsoflias 2012:34.

78 The certificate of formation must state: “Notice is hereby given pursuant to Section 18.215(b) of the LLC Act that the debts, liabilities, and obligations incurred, contracted for, or otherwise existing with respect to a particular series of the LLC, shall be enforceable against the assets of such series only and not against the assets of the LLC generally, or any other series thereof, and none of the debts, liabilities, obligations, and expenses incurred, contracted for, or otherwise existing with respect to the LLC generally, or any other series thereof, shall be enforceable against the assets of such series.” See Cushing 2012:4-5.

79 Cushing 2012:4-5; Ribstein 2008:42.

80 Conaway & Tsoflias 2012:34.

81 Goforth 2007:390.

82 Goforth 2007:390.

83 Blake 2010:10; Goforth 2007:390.

84 Del. Code. Ann. tit. 6, § 18-215(g) *Delaware Limited Liability Company Act*.

85 Beard 2008:14.

The Illinois statute uses more explicit terms and phrasing in respect of the formation of the series LLC than the wording found in the *Delaware Limited Liability Company Act*. Under the Illinois statute, the formation of a series LLC must adhere to more extensive requirements. In order to acquire limited liability under Illinois law, the series LLC must file “a certificate of designation for each series which is to have limited liability”.<sup>86</sup> The statute requires that “the name of the series with limited liability must contain the entire name of the limited liability company and be distinguishable from the other names of the other series set forth in the articles of organization”.<sup>87</sup> The statute is very explicit concerning the specific information to be filed about each series. Information concerning the names of the members or managers responsible for the management of the series must be made available in each certificate of designation for every series.<sup>88</sup> Any changes to any of the information originally contained in a certificate of designation of a series must be effected by way of filing a formal amendment to that certificate.<sup>89</sup>

Generally, as a second requirement, it is essential for separate entity records, accounts and bank accounts to be maintained.<sup>90</sup> The *Delaware Limited Liability Company Act* does not provide any direction on how detailed the records must be or which assets must be accounted for.<sup>91</sup> However, the records must reasonably identify both the assets and the liabilities of each series.<sup>92</sup> The assets associated with a series “may be held directly or indirectly, including in the name of each series, in the name of the limited liability company, through a nominee or otherwise”.<sup>93</sup> Under Illinois series LLC provisions,<sup>94</sup> it is also required that the assets in a series be completely separated from the assets in other series as well as the assets in the master LLC.<sup>95</sup>

The distinction between the Delaware and Illinois statutes is clearly located in the respective statutes’ provisions on the formation of a series

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86 805 Ill. Comp. Stat. Ann 180/37-40(b) *Illinois Limited Liability Company Act*.

87 805 Ill. Comp. Stat. Ann180/37-40(c) *Illinois Limited Liability Company Act*.

88 805 Ill. Comp. Stat. Ann180/37-40(d) *Illinois Limited Liability Company Act*.

89 805 Ill. Comp. Stat. Ann180/3740(d) *Illinois Limited Liability Company Act*.

90 Del. Code. Ann. tit. 6, § 18-215(b) *Delaware Limited Liability Company Act*; Beard 2008:14.

91 Goforth 2007:391.

92 Del. Code. Ann. tit. 6, § 18-215(b) (2006) *Delaware Limited Liability Company Act*.

93 Del. Code. Ann. tit. 6, § 18-215(b) *Delaware Limited Liability Company Act*.

94 The Delaware statute does not specifically provide for the possibility of separate and different business purposes or investment objectives by a series from its master or other series. Under the Illinois statute, the separation of the business purposes and investment objectives of a series from its master and other series must be explicitly provided for in each series’ operating agreement. There is no explicit reason for this additional requirement, but it is submitted that the formality is aimed at supporting the separate record-keeping requirement. See Goforth 2007:294.

95 Beard 2008:14; Mertens 2009:274.

LLC. The Illinois statute seems to outdo the Delaware statute. The Illinois statute improves on the Delaware law by explicitly providing for the separation of each series from the master and each other, thereby removing much of the ambiguity concerning the judicial treatment of the series. Currently, the Illinois statute is the only statute containing such language.<sup>96</sup> Delaware has not followed suit by explicitly providing for the compartmentalisation of series and their assets, but has adopted some of the other provisions.<sup>97</sup>

Once these two mandatory requirements for the creation of the series LLC have been met, it may be presumed that the intended limited liability has been acquired. Under the Delaware series statute, as well as the statutes of the other states, the liabilities of one series can only be charged to the property contained therein, thus insulating the other series and the parent entity from being affected by such liabilities.<sup>98</sup> The series LLC also allows for relatively easy transfer of property from one series to another, as the transfer of an LLC interest has proven to be much easier and cost-effective<sup>99</sup> than transferring an undivided interest in real property.<sup>100</sup> A single series is not dissolved by the dissolution of any other series; the dissolution of the master LLC, however, dissolves all the series.<sup>101</sup> In addition, if the LLC undergoes insolvency proceedings, it would not be allowed to make a distribution under the Delaware law, but if a series were to go insolvent, a distribution may be made either by the master LLC or any other series in so far as the fair value of the series' assets exceeds its liabilities.<sup>102</sup>

The law of the state under which the series LLC is formed outlines the rights, powers and duties of each series.<sup>103</sup> The majority of the states require the operating agreement<sup>104</sup> to state the limitation of liability attached to the

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96 Mertens 2009:295.

97 Mertens 2009:295.

98 Beard 2008:14.

99 The transfer of a subseries as an interest allows a company to avoid the real-estate closing costs associated with the transfer of real property, as well as the transfer tax costs, the recording of multiple deeds and related costs, and mitigates issues that arise in respect of property titles. The series LLC statute also provides for tax-free transfers of assets within the LLC. See Blake 2010:7.

100 Blake 2010:7.

101 Del. Code. Ann. tit. 6, § 18-215(k) *Delaware Limited Liability Company Act*; Mertens 2009:274; Dawson 2010:520.

102 Del. Code. Ann. tit. 6, § 18-215(h) *Delaware Limited Liability Company Act*; Goforth 2007:387.

103 Mertens 2009:274.

104 The operating agreement should provide as follows: "The debts, liabilities and obligations incurred, contracted for or otherwise existing with respect to a Series shall be enforceable against the assets of such Series only and not against any other assets of the Company generally or other Series or none of the debts, liabilities, obligations and expenses incurred, contracted for or otherwise existing with respect to the Company generally or any other Series shall be enforceable against the assets of such Series. Separate and distinct records shall be maintained for each and every series, and assets associated

assets held by that particular series, in order to provide sufficient notice to creditors who wish to invest in the series.<sup>105</sup> Generally, each series acts individually in accordance with its operating agreement.<sup>106</sup> A series may have a different business purpose from the other series and the master LLC, and can have its own members, managers and voting rights. However, the limited liability of a series within a series LLC can only be enjoyed if the fundamental guidelines concerning the formation and regulation thereof are adhered to.

Although the formation of the series LLC seems simple enough, that is where the simplicity ends. Certain commercial aspects concerning the use of the series LLC still need clarification. The issue underlying legal concerns about bankruptcy and taxation is that of the “separateness” of the series entity. The “separateness” of the series LLC is a matter of contention, and Delaware is yet to declare whether the series LLC is to be regarded as a separate entity for the purposes of tax and bankruptcy law.<sup>107</sup>

#### 4. The “separateness” of the series LLC

It is general practice that a federal court will apply state law when the subject matter of the case is of a nature usually left to the states.<sup>108</sup> There is, however, an exception: Federal law may explicitly pre-empt state law.<sup>109</sup> Traditionally, the establishment and regulation of business entities is a matter of state, and it is, therefore, up to the state to determine whether or not an entity is regarded as separate.<sup>110</sup> The Delaware statute does not explicitly provide that each series is a legal entity distinct from the original series.<sup>111</sup> The Illinois statute, on the other hand, explicitly provides that each series will be “treated as a separate entity to the extent set forth in the articles of the organization”.<sup>112</sup> Furthermore, the Illinois statute states that “each 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”.<sup>113</sup>

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with any such Series shall be accounted for separately from other assets of the Company, or any other Series of the Company. The Members shall not commingle the assets of one Series with the assets of any other Series. The Certificate of Formation shall contain notice of the limitation of liabilities of a Series as to other Series in conformity with Section 18-215 of the Act.” See Cushing 2012:4-5.

105 Mertens 2009:275.

106 Beard 2008:14.

107 Dawson 2010:524.

108 Dawson 2010:524.

109 Dawson 2010:524.

110 Dawson 2010:524.

111 Goforth 2007:388.

112 805 Ill. Comp. Stat. Ann 180/37-40(b) *Illinois Limited Liability Company Act*.

113 805 Ill. Comp. Stat. Ann 180/37-40(b) *Illinois Limited Liability Company Act*

In terms of the preliminary provision<sup>114</sup> for the series LLC under Delaware law, only the master LLC has the right to conclude and enter into transactions on behalf of its series entities, as well as the right to sue on behalf of any series entity.<sup>115</sup> The initial Delaware statute provided only for the segregation of assets and liabilities as well as management within the LLC, but a series LLC could not own property.<sup>116</sup> In 2007, the Delaware court confirmed in *GxG Management LL.C. v Young Bros. and Co., Inc.* that the Delaware series LLC was a non-entity and ought to be considered as a series interest only.<sup>117</sup> However, while the Delaware statute proved wholly insufficient for recognition of the series as a business entity, the Illinois series LLC statute provided extensively for the recognition and regulation of the series LLC.

Under Illinois series LLC legislation, a series may be treated as a separate entity in so far as this is provided for by the articles of organisation.<sup>118</sup> The statute specifically provides 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”.<sup>119</sup> After the unfavourable ruling for the Delaware series LLC, the statute underwent certain amendments, but did not follow the state of Illinois’ lead. The subsequent changes allow the various series of a series LLC to contract for, and hold title to real, personal and intangible property.<sup>120</sup> The law provides for flexibility in respect of the manner in which assets are held — “directly or indirectly, including in the name of such series, in the name of the limited liability company, through a nominee or otherwise”.<sup>121</sup> Despite the amendment to the Delaware law, and the specificity of the Illinois statute concerning the limitation of liability afforded to the series LLC, neither statute explicitly states that the series

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114 The series LLC initially originated under the *Delaware Business Trust Act*, but no explicit requirements were provided for its creation and regulation. It was only through the enactment of the *Delaware Limited Liability Company Act* in 1996, and its amendment in 1997 to include a “series” provision, that the series LLC acquired statutory recognition. See Conaway & Tsoflias 2012:9.

115 Blake 2010:9.

116 The amendment to include a “series” in the Delaware law created statutory provision for “series” members, managers, LLC interests and assets independent of the Act’s default managerial section; permitted the series to carry on any lawful purpose, be it for profit or not; created records and notice systems to ensure that the liabilities of a series is enforceable against that series only, and provided for the future creation of other classes or groups. In a further amendment in 2006, the “series” is defined as a “person” who includes “any other individual or entity (or series thereof) in its own or any representative capacity”. See Conaway & Tsoflias 2012:12.

117 *GxG Management LL.C. v Young Bros. and Co., Inc.*, 2007 WL 551761 (D.Me.2007); Blake 2010:9.

118 Blake 2010:9.

119 Blake 2010:9.

120 Del. Code. Ann. tit. 6, § 18-215(c) (2007) *Delaware Limited Liability Company Act*.

121 Del. Code. Ann. tit. 6, § 18-215(b) (2007) *Delaware Limited Liability Company Act*.

LLC is deemed to be a separate entity: “Separateness” is only implied by the extent to which liability is limited under the series LLC provisions.

As yet, the various series of a Delaware LLC cannot be said to be separate entities for state law purposes, but they are treated similar to state law entities in several significant respects.<sup>122</sup> The majority of the other states’ series LLC statutes, with the exception of Illinois, are similar to the Delaware statute in that the various series of a series LLC are not separate entities for state law purposes.<sup>123</sup> As no state law is currently on point with regard to the issue of “separateness” of the series LLC, it is left to federal law to determine whether a business entity is a separate entity.<sup>124</sup> Such determination is usually required for the purposes of federal taxation and filing a petition for bankruptcy. There is no single, consistent approach to determine the “separateness” of the series LLC to accommodate both federal taxation and bankruptcy; such determination requires extensive consideration of the various legal theories applicable to the area of law concerned.

#### 4.1 “Separateness” in taxation

The series LLC statutes do not determine whether a single series LLC is considered a separate state law entity.<sup>125</sup> “Separate entity” classification for federal tax purposes depends on federal tax law, and not on whether the entity is recognised as such under state law.<sup>126</sup> However, various commentators argue that, where there is no separate legal entity under state law, federal tax law may consider “separate entity” status if a certain quantum of business activity and purpose exists.<sup>127</sup>

The regulations issued by the United States Internal Revenue Service for section 7701 of the Internal Revenue Code<sup>128</sup> may help to establish a procedure to classify an entity as a separate entity for federal tax purposes and more.<sup>129</sup> The first question is whether the organisation is a separate entity distinct from its owners.<sup>130</sup> If an organisation is not regarded as a

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122 Levine & Stahl 2011:2.

123 Levine & Stahl 2011:2.

124 Dawson 2010:525.

125 Mertens 2009:282.

126 Levine & Stahl (2011:7) cite the matter *Comr. v Culbertson* 37 AFTR 1391: 1395, where the supreme court held that the consideration of an entity as a partnership for tax purposes depends on whether “the parties in good faith and acting with a business purpose intended to join together in the present conduct of the enterprise, after considering all of the facts and circumstances”. Relevant facts include: the agreement, the conduct of the parties in execution of its provisions, their statements, the testimony of disinterested persons, the relationship of the parties, their respective abilities and capital contributions, the actual control of income and the purposes for which it is used, and any other facts throwing light on their true intent”.

127 Mertens 2009:282.

128 Treasury Regulations §§ 301.7701.

129 Dawson 2010:525.

130 Treasury Regulations §§ 301.7701-2(a); Dawson 2010:525.

separate entity under state law, it may be afforded separate entity status under federal law, provided that there is a well-defined level of business activity and purpose within the organisation.<sup>131</sup> The second question is whether the relevant code contains special provisions concerning the regulation of the entity, such as a provision governing the way in which the entity is treated for tax purposes.<sup>132</sup> If no such provision exists, the “separateness” of the entity will depend on its classification — whether it is a trust or a business entity.<sup>133</sup> Thus, the purpose of a series formed in terms of the *Delaware Limited Liability Company Act*, and the extent to which it functions in terms of this statute, will determine whether it will be regarded as a trust or a business entity.

The classification of a series as either a trust or business entity will make it easier to determine whether it functions as a separate entity, although some argue that certain series may not strictly adhere to the classification characteristics of either structure.<sup>134</sup> Despite the availability of legislation and LLC-related case law to provide guidance on what constitutes a separate entity, there is a lack of definitive authority concerning the classification of the series LLC. Until such authority is established, there can be no legal certainty regarding the classification of the series LLC as a separate entity. Currently, the “separateness” of an entity will have to be determined on a case-by-case basis with reference to the available legislation and applicable case law.

Various aspects of state and federal law have, however, provided some insight on possible approaches to confer “separateness” on an entity. The Internal Revenue Service states that it would consider a joint venture or contractual agreement to be a separate entity if the participants thereto carry on a trade, business or financial operation, and divide the profits arising from it among themselves.<sup>135</sup> An arrangement in terms of which the participants merely share costs or expenses does not qualify as a separate entity.<sup>136</sup> Similarly, the co-ownership of property, even rented or leased property, will not qualify as a separate entity.<sup>137</sup> Thus, the determination

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131 Dawson 2010:525.

132 Dawson 2010:525.

133 Dawson 2010:525-526. The classification of either refers to its inherent characteristics. The trust serves to conserve property, and its structure allows for the separation of responsibilities associated with the preservation of the trust’s assets, although trusts generally do not have a business objective. A business trust is accordingly not classified as a trust, and a court will apply the “substance over form” rule to determine whether the said trust is classified as such or not. A business entity, on the other hand, refers to any entity that is not classified as a trust, and will be considered a business entity if it carries on a profit-making business. See Dawson 2010:527.

134 Dawson 2010:527.

135 Treasury Regulations § 301.7701-1(a)(2) (as amended in 2009).

136 Dawson 2010:529.

137 Treasury Regulations § 301.7701-1(c).

of “separateness” for taxation purposes will depend on the relationship between the owners of the entity and their assets.<sup>138</sup>

The operating agreement will prove useful in this regard. The content of the organisational documents is likely to have the greatest effect on whether a series will be treated as a separate entity for both state and federal law purposes.<sup>139</sup> If a series is formed under Delaware or Illinois law, and complies with all the formation requirements, such a series will most likely be considered a separate entity, because it would adhere to the organisational characteristics required for the formation of an LLC, and a subsequent series LLC.<sup>140</sup> Thus, the series with the best chance of receiving separate entity status is the one that maintains an independent business purpose, limits joint activity among the series, and has a varying ownership and management scheme.<sup>141</sup>

Ordinarily, states piggyback on federal tax classification rules, but state taxing authorities have begun to view the “separateness” issue as existing independently from federal considerations.<sup>142</sup> Statutory trust law may provide some guidance on the manner in which a series LLC may be taxed. In 2008, the state of Massachusetts released a ruling that a Delaware series should be treated as a separate, taxable entity. The ruling considered a Delaware series to be a successor entity to a Massachusetts business trust; it recognised that a series may be created in future.<sup>143</sup> The ruling requested that each Delaware series be classified and treated as a separate entity for Massachusetts income tax purposes, and that each such series be classified for Massachusetts income tax purposes in accordance with its federal classification.<sup>144</sup> In fact, the Internal Revenue Service has ruled that the series of the Delaware statutory trust may be considered a distinct taxable entity for federal tax purposes.<sup>145</sup> Mertens<sup>146</sup> submits that the Internal Revenue Service may eventually follow suit in respect of series LLC, and declare them to be separate entities for separate taxation, as in the case of the statutory trust.

## 4.2 “Separateness” in bankruptcy

While entity law focuses on the formalities of the entity structure, enterprise law addresses the substantive realities of corporate existence.<sup>147</sup> According to enterprise law, corporations within a corporate group may act as a single

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138 Dawson 2010:529.

139 Dawson 2010:533.

140 Dawson 2010:533.

141 Dawson 2010:533.

142 Bishop 2009:490.

143 Bishop 2009:490.

144 Bishop 2009:490.

145 Mertens 2009:282.

146 Mertens 2009:282.

147 Bahena 2010:810.

enterprise with a single goal, rather than as distinct entities.<sup>148</sup> If applied correctly, enterprise law permits creditors to cross corporate boundaries and collect from the larger group.<sup>149</sup> Enterprise law evolved as an alternative to the more rigid entity law principles.<sup>150</sup> In its conservative application, it is nearly indistinguishable from the veil-piercing doctrine, but in its radical version, it calls for a complete disregard of entities in a corporate structure, with the court determining the scope of the enterprise.<sup>151</sup>

Substantive consolidation serves as the enterprise law alternative to the veil-piercing doctrine, and finds application in bankruptcy law.<sup>152</sup> Bahena<sup>153</sup> explains that “[i]n substantive consolidation the court combines assets and liabilities of affiliated debtors into one bankruptcy estate and eliminate intercompany claims and guarantees”. The purpose of substantive consolidation is to achieve overall fairness to creditors, whose economic well-being as a whole outweighs any negative effect on any one creditor.<sup>154</sup> As the doctrine developed, courts insisted that it be used sparingly; currently, however, substantive consolidation is the dominant bankruptcy technique used by courts to recognise and liquidate large public companies.<sup>155</sup>

The 2007 amendment to the *Delaware Limited Liability Company Act* defined a series as a “person”, which includes any entity (or series thereof),<sup>156</sup> However, such recognition is for business purposes only. The amendment did not imbue the series with legal personhood independent of its organising entity status, nor did it enable the series to utilise merger statutes.<sup>157</sup> It is strongly argued that the definition for a series does not

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148 Bahena 2010:810. According to Bahena, the predominant theory behind enterprise law is that the various legal entities that are operated as the same enterprise ought to share both the rewards and the risks of that enterprise.

149 Bahena 2010:810.

150 Bahena 2010:810.

151 Bahena 2010:810.

152 Bahena 2010:811.

153 Bahena 2010:811.

154 Bahena 2010:811. At 812, Bahena argues that asset protection and the subsequent limitation of liability are most harmful in the case of unsecured creditors. Judgement in the case of civil liability is an unsecured debt and, therefore, unsecured creditors are only entitled to their claims after the secured creditors' claims have been settled.

155 Bahena 2010:811.

156 “Person” means a natural person, partnership (whether general or limited), limited liability company, trust (including a common-law trust, business trust, statutory trust, voting trust or any other form of trust), estate, association (including any group, organisation, co-tenancy, plan, board, council or committee), corporation, government (including a country, state, county or any other governmental subdivision, agency or instrumentality), custodian, nominee or any other individual or entity (or series thereof) in its own or any representative capacity, in each case, whether domestic or foreign. See Del. Code. Ann. tit. 6, § 18-101(12) (2007) *Delaware Limited Liability Company Act*.

157 Conaway & Tsofilias 2012:38.

provide for “personage” for the purposes of federal bankruptcy laws.<sup>158</sup> From a practical angle, addressing the question from either side will have far-reaching implications. If a series can file for bankruptcy in its own name,<sup>159</sup> creditors will be confined to the assets held in that series only.<sup>160</sup> If, however, a series is unable to file for bankruptcy in its own name, the master LLC will be required to do so.<sup>161</sup> If that is the case, the assets in the master LLC, the insolvent series and any other series will become part<sup>162</sup> of the bankruptcy estate.<sup>163</sup> This, of course, completely contradicts the purpose of the limited liability afforded by the series LLC structure.

The contention between these two alternatives stems from the clash between federal law and state law. Once again, the “separateness” of the series LLC becomes a factor affecting its regulation for bankruptcy purposes. It is submitted that addressing the “separateness” issue will require consideration of case law where the bankruptcy court allowed LLCs to file a petition for bankruptcy, and the manner in which the court interpreted the question of whether a series is a “person”.<sup>164</sup>

In 2001, the bankruptcy court was presented with the question of whether an LLC was a person eligible to file for bankruptcy as a debtor based on the court’s first impression of the LLC and its activities.<sup>165</sup> The court considered two factors, namely whether the LLC was a legal entity, and whether the LLC had several characteristics similar to those entities explicitly granted the authority to file for bankruptcy. As further considerations, the court focused on the member-managers’ protection against personal liability; the LLC’s right to organise for any lawful purpose; the existence of member-owners with the authority to manage

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158 Conaway & Tsofilias 2012:39.

159 Should a bankruptcy court consider a series LLC to be a “person” with a corresponding ability to be a debtor, an individual series may be able to file for bankruptcy. Each series will be able to file for bankruptcy without affecting the master LLC or any other series. See Gingerich 2009:209.

160 Dawson 2010:521; Goforth 2007:388.

161 Dawson 2010:521.

162 If a series is not considered to be a “person”, the entire LLC will be treated as one entity, and ultimately held liable. See Gingerich 2009:209.

163 Dawson 2010:521.

164 Dawson 2010:521.

165 Dawson 2010:522. ICLNDS Notes Acquisition LLC (*In re ICLNDS Notes Acquisition, LLC* 259 B.R.: 289,292 (Bankr.N.D. Ohio 2001)) filed a voluntary petition under chapter 7 of the Bankruptcy Code. As there was no specific reference to an LLC in the code, the court held that the word “included” in section 102(3) was not limited, and thus, the LLC was not barred from filing a petition for bankruptcy, irrespective of the fact that the provision only refers to individuals, partnerships and corporations. The court also examined the characteristics of the LLC, which was organised under Ohio state law, and held it to be a partnership/corporation hybrid. The court concluded that “corporations and partnerships are eligible to be debtors, and because an LLC draws its character from both of those forms of doing business, an LLC is similar enough to those entities” that it may be a debtor in terms of the code.

the company in proportion to their share of capital contributions, and the partnership-like tax status.<sup>166</sup>

It is argued that these considerations will be relevant when examining the eligibility of the series LLC to file a petition for bankruptcy. From everything discussed so far with regard to the series LLC, we know that the structure of the series LLC is akin to the structure of the LLC. Thus, a series LLC formed under the Delaware statute, the Illinois statute or any statute resembling either of these would probably pass the “likeness test” articulated by the court in *In re ICLNDS*.<sup>167</sup> Accordingly, it is very possible that a series LLC may be considered a separate entity for the purposes of applying bankruptcy law. It is, however, not enough to consider the possibility of the series LLC being able to file a petition for bankruptcy, but also the way in which bankruptcy law is to be applied if a series LLC is considered a separate entity for bankruptcy purposes.

### 4.3 Conclusion

The issue of the “separateness” of the series LLC remains uncertain in the broader legal context, but is not entirely without regulatory assistance. However, until the legislature and the courts take a stance on the matter for regulation purposes, practitioners will have to be attentive to how the organisational documents have been drawn up and executed.<sup>168</sup>

## 5. Limited liability

Liability is the central method for enforcing civil law.<sup>169</sup> If a firm is able to protect its assets from collection by creditors, it can reduce its liability – it can become “judgement-proof”.<sup>170</sup> However, the possibility of limiting the liability of persons responsible for the management and economic undertakings of an enterprise may subvert the enforcement of civil law by hindering or preventing the collection of remedies by judgement creditors. It is argued that the extreme, unfounded application of limited liability will be detrimental to society at large, and that the avoidance of liability by persons who recklessly pursue business undertakings will encumber the broader economy.

With regard to the LLC and the series LLC, the predictability of liability is crucial for the functionality of the structure. However, the ability to hold a defendant liable is critical for recognising and upholding various civil

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166 Dawson 2010:523.

167 Dawson 2010:523.

168 Dawson 2010:536.

169 Bahena 2010:812.

170 Bahena 2010:812. Reducing liability subverts civil law action against an enterprise by either reducing or eliminating judgement creditors’ ability to collect remedies. Thus, if a firm can avoid liability, it can dampen the incentive to avoid risky, liability-producing behaviour.

rights, such as the civil rights of minorities, the rights to access by the disabled, and the right to be compensated for the harm or injury inflicted on one's person, property or reputation.<sup>171</sup> Despite the delicate balance that ought to be maintained between creditors' debt collection rights and debtors' options to avoid liability in order to engage in innovative business endeavours, the scales seem to be tipped in the debtors' favour.<sup>172</sup> Bahena noted:

A system that is too pro-debtor will result in higher costs of borrowing for contract debtors, and a higher rate of uncompensated loss for tort victims. A system that is too pro-creditor will result in higher costs for social services as debtors become too destitute to afford the necessities of life.<sup>173</sup>

The urgency of the need to predict limited liability and govern its application is evident. Unpredictable liability gives rise to inefficiency, which subjects all participants in the system to potential harm.<sup>174</sup> With regard to asset segregation, specifically referring to the series LLC, predictable liability requires identifiable and stable boundaries, both among and within each enterprise.<sup>175</sup> It is argued that the liability of series LLCs can only be fair and predictable once the legal system clarifies the strength of liability shields within a series LLC, and establish boundaries for their application.<sup>176</sup>

## 5.1 Judicial recognition of limited liability for the series LLC

Entity law focuses on the formal legal boundaries that prevent the creditors of one entity from accessing the assets of another, related entity.<sup>177</sup> Entity law operates on the assumption that every corporation is a separate legal entity with its own legal rights and duties.<sup>178</sup> Under traditional entity law, the only way to cross such formal boundaries between related corporations is to pierce the corporate veil.<sup>179</sup> Piercing of the corporate veil takes place in exceptional instances only — when creditors provide evidence of lack of formal separation between affiliates of a corporation.<sup>180</sup> The application of the veil-piercing doctrine occurs on a case-by-case basis and, although it is subject to strict technical requirements, its application varies widely among courts.<sup>181</sup> There is currently no case law on the effectiveness of internal liability shields, either domestic or foreign.<sup>182</sup>

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171 Bahena 2010:812.

172 Bahena 2010:813.

173 Dawson 2010:536.

174 Bahena 2010:814.

175 Bahena 2010:814.

176 Bahena 2010:814.

177 Bahena 2010:809.

178 Bahena 2010:809.

179 Bahena 2010:810.

180 Bahena 2010:810.

181 Bahena 2010:810.

182 Fink 2011:602.

The idea of limited liability and the separation of a corporation's personal liability from its invested shareholders is deemed to be one of the "first principles" of American law.<sup>183</sup> Economically, the recognition of limited liability is strongly motivated, and argued to be essential for the functioning of an efficient capital market.<sup>184</sup> The use and structuring of the series LLC is virtually unlimited and flexible approaches are provided for by law.<sup>185</sup> A series LLC can be tailored to the industry and the needs of each owner, and each series LLC may have its own management structure.<sup>186</sup> It has been said that the structure of the relationship may affect the court's application of the veil-piercing doctrine or substantive consolidation in the case of bankruptcy.<sup>187</sup> The "separateness" of each series as an entity is, therefore, an issue that will affect the recognition of the limited liability offered under the series provisions.

The promulgation and recognition of the *Uniform Limited Liability Company Act*<sup>188</sup> by the National Conference of Commissioners on Uniform State Laws greatly influenced the implementation of LLCs throughout the United States of America. The adoption of the *Act* by all 50 states in 1996 effectively addressed the concern that limited liability would not be recognised by a court outside the jurisdiction in which the LLC is registered. However, despite the promise shown by the model statute formula in respect of the series LLC, the National Conference of Commissioners on Uniform State Laws later failed to include the concept of the series LLC in the revised *Act*.<sup>189</sup> The reason for this may be the uncertainty surrounding the regulation of the series LLC in instances of bankruptcy and the possible override of the limited liability of a business through a court's discretionary application of the veil-piercing doctrine.<sup>190</sup> By 2010, there had not been any

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183 Beard 2008:15.

184 Beard 2008:15.

185 Mertens 2009:276.

186 Mertens 2009:276.

187 Mertens 2009:276.

188 The *Uniform Limited Liability Company Act* was adopted in 2006, but the drafting committee rejected the notion of the series LLC after considering the series LLC provisions in the Delaware LLC statute and those of the other series LLC states. The drafting committee based its refusal on concerns it had regarding the implementation of the series LLC. The primary concern was the possibility for misuse of the series LLC structure by sophisticated Delaware lawyers to subdivide assets in business operations and to provide unwarranted hopes for low-cost asset protection. The committee felt that what was good for Delaware and other highly sophisticated deals was not necessarily good for the LLC law of other states. See Bahena 2010:804.

189 Beard 2008:35.

190 The explicit provision against piercing the veil in the parent-subsidiary context in respect of series LLCs affronts state policy on veil piercing. The structure of the LLC does not impede the veil piercing strategies of a state, but the series LLC requires a state to alter such strategies. The National Conference of Commissioners on Uniform State Laws felt that this impediment was too great for the time being. See Beard 2008:35.

published cases indicating the manner in which a series LLC will function in a non-series LLC state.<sup>191</sup>

As mentioned, very few states have adopted series LLC legislation thus far, and not all state statutes address the creation and regulation of the series LLC as extensively as the Illinois and amended Delaware LLC laws. Moreover, each state has its own perception of the degree of limited liability it is prepared to recognise. Thus, despite the recognition of limited liability by a state, each state will regulate a “foreign” series LLC in terms of its own state law.<sup>192</sup> It must be remembered that state courts are generally required to recognise the laws and policies of other states under the auspices of the full faith and credit clause;<sup>193</sup> this undoubtedly extends to the series LLC statutes of Delaware and the other states.<sup>194</sup> A state court may, however, refuse to recognise certain series LLC features if the court found an overriding public policy against those features.<sup>195</sup>

Thus, there is a founded apprehension that a court of a non-series state may choose not to recognise the limited liability awarded to a business in terms of its own state law.<sup>196</sup> Furthermore, apart from the Illinois series LLC statute and the amendments to the Delaware statute in respect of the series LLC, not all series statutes adequately provide for the extent to which limited liability is afforded, neither for a local nor foreign series LLC.<sup>197</sup> This ambiguity concerning the extent to which limited liability is applied enables a judge to resort to the state’s underlying policy concerning veil piercing, especially under contract or tort law. Judges may then feel encouraged to reject the series LLC structure, thereby limiting the limited liability of a business with the application of the veil-piercing doctrine.<sup>198</sup>

The development of case law seems to suggest that courts generally apply state law when adjudicating on limited liability and veil piercing.<sup>199</sup> However, courts apparently do not apply limited liability universally, despite the availability of limited liability under state legislation; the application of veil piercing at a judge’s discretion hinders businesses’ reliance on the value of the limited liability provision.<sup>200</sup> It must be noted that some

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191 Blake 2010:16.

192 Most states’ series statute provides that the formation law of the relevant jurisdiction will regulate the organisation, internal affairs and member liability of foreign series LLCs. See Beard 2008:24.

193 United States Constitution Article IV § 1, which empowers Congress to determine the effect that each state must give to other states’ public acts or laws.

194 Bahena 2010:804.

195 Bahena 2010:804.

196 Beard 2008:23.

197 Beard 2008:23.

198 Beard 2008:23.

199 Beard 2008:13.

200 It is not uncommon for judges to craft equitable rules for attaching personal liability under certain circumstances, despite the provision for limited liability for a business in terms of its notice of organisation and under state legislation. The degree of application of the veil-piercing doctrine depends on the state’s

states explicitly require their courts to effect corporate veil piercing when addressing LLC-member limited liability.<sup>201</sup> Thus, it is concluded that, although much of the concerns regarding the recognition of LLCs have been mitigated, the variation in veil-piercing standards and the varying degree to which LLC members are afforded limited liability from one state to another may affect an LLC's decision to do business in a particular state.

The series LLC seems to be more likely to be subject to veil piercing, because it aims to exclude personal liability of its members and managers altogether. In this context, however, the uncertainties concerning veil piercing are compounded and magnified,<sup>202</sup> primarily because of creditors' general failure to note the limited liability of each series, as most statutes only require the LLC to note the inclusion of a series in its articles of organisation.<sup>203</sup> That is why the maintenance of separate records is such an important requirement for the formation of a series LLC.

It is recommended that perhaps the most effective method for promoting the market for series LLC law is by enacting a federal "choice of business organisation structure" statute.<sup>204</sup> The United States Constitution provides for the granting of authority to regulate choice-of-law rules by Congress in terms of the full faith and credit clause<sup>205</sup> and the commerce clause,<sup>206</sup> but Congress rarely seems to exercise this power.<sup>207</sup> However, such a federal choice-of-law statute would probably still not adequately address the fundamental impediment of the series LLC — each state's super-mandatory veil-piercing doctrine, which renders the structure of the series LLC both uncertain and ineffectual.<sup>208</sup>

## 5.2 Setting boundaries for limited liability

It goes without saying that there is founded apprehension in many that the limited liability afforded by the series LLC structure may have serious implications for an aggrieved party's capacity to hold the entity liable. On the other hand, there exists a very real fear that the internal liability shields

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interest therein and, therefore, judges exercise a significant amount of discretion in determining and applying the doctrine. See Beard 2008:20-21.

201 Beard 2008:13.

202 Mertens 2009:307.

203 Mertens 2009:307. Such notice will be nearly impossible to acquire if the series has a different name than the master LLC.

204 A federal choice-of-law statute may solve the unpredictability in respect of the application of organisational state law when contracting. Profs Ribstein and O'Hara (in Beard 2008:33) note that "[a] clear statutory mandate would assure the parties of the effect of their contract at the time of entering into it, and thereby help them price the contract, design contract terms, and avoid litigation".

205 United States Constitution Article IV § 1.

206 United States Constitution Article I § 8, which confers on Congress the power to regulate taxation, bankruptcy, coinage and all acts associated with commercial conduct.

207 Beard 2008:33.

208 Beard 2008:33.

of the series LLC may easily be subjected to “veil piercing”, as the very purpose of the series LLC is to exclude personal liability altogether.<sup>209</sup> It is, therefore, crucial for boundaries to be created to provide a framework for the application of limited liability. The possibility of establishing boundaries for the limitation of liability has predominantly been addressed under the auspices of entity law. However, Bahena<sup>210</sup> submits that utilising pure entity law principles limits the courts’ determination of such boundaries. Legal scholars are progressively acknowledging that “entity law [is] not the inevitable product of the corporate personality but a legal concept to serve certain objectives ...”.<sup>211</sup>

Generally, the strength of a firm’s liability boundaries is located on a continuum that ranges from impenetrable to non-existent. For a series LLC, however, four theoretical principles may be used to establish the potential for basic boundaries.<sup>212</sup> The first option entails establishing impenetrable boundaries between the various series in a series LLC, with each series being treated as a separate entity with separate liability. However, it is unlikely for any court to uphold limited liability in every situation.<sup>213</sup> No corporation has ever been completely free from veil-piercing and equity rulings.

The second option examines the rebuttable presumption of separate entity status.<sup>214</sup> Under entity law, courts may assume that a corporation within a corporate group is an independent legal entity, with liability distinct from other corporations in the group.<sup>215</sup> Courts generally respect entity separateness in the absence of compelling circumstances that bring equity into play.<sup>216</sup> If a court decides to take this route, it would inevitably be inclined to apply this framework in circumstances of bankruptcy too, and would thereby assume that each series maintains limited liability in bankruptcy.<sup>217</sup> If this route is employed, the assumption is also subject to rebuttal through enterprise liability and substantive consolidation.<sup>218</sup> These doctrines would be applied when a court analyses the actual boundaries between the series by enquiring about the financial interdependence of the series, the economic integration of each series, the series LLC’s participation in the series’ decision-making processes, and whether the series LLC is viewed as a single, integrated enterprise by the public.<sup>219</sup>

The third option entails the application of enterprise law and its doctrine of substantive consolidation.<sup>220</sup> Unlike entity law, enterprise law does not

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209 Fink 2011:603.

210 Bahena 2010:814.

211 Bahena 2010:814.

212 Bahena 2010:814.

213 Bahena 2010:815.

214 Bahena 2010:815.

215 Bahena 2010:815.

216 Bahena 2010:816.

217 Bahena 2010:816.

218 Bahena 2010:816.

219 Bahena 2010:816.

220 Bahena 2010:817.

commence with the assumption of liability boundaries, but examines the situation as a whole to determine whether various entities are engaged in a joint business venture.<sup>221</sup> The Delaware courts follow such an enterprise approach.<sup>222</sup> The primary criticism against the application of the enterprise approach is the potential for unpredictability.<sup>223</sup> Being an equitable doctrine, it is not subject to formulaic application, which means that there is no guiding authority as to when the doctrine may be applied.<sup>224</sup>

The fourth and last option involves not recognising the boundaries between the various series of the series LLC in bankruptcy.<sup>225</sup> This option would most likely arise where the bankruptcy court decides that a series is not a “person” under the Bankruptcy Code, thus precluding the series from filing for bankruptcy.<sup>226</sup> Whether a series can file for bankruptcy and, if so, whether courts will grant it limited liability, depends on the goals of bankruptcy law.<sup>227</sup> Bankruptcy goals include “protect[ing] ... the interests of creditors and the equitable distribution of the assets of the debtor’s estate”.<sup>228</sup>

The application of any of these theories will ultimately depend on the matter before the court and the issue on which the court is expected to adjudicate.<sup>229</sup> As yet, no court has adjudicated on a matter involving a series LLC; therefore, the relevance of the proposed theories remains to be tested.

## 6. Bankruptcy law and the series LLC

Society allows for bankruptcy under the auspices of a social contract to protect business risk-taking.<sup>230</sup> One of the most fundamental features of the series LLC under Delaware law is the possibility for debts, liabilities, obligations and expenses of a single series to be enforceable only against the assets of that particular series, and not against the master LLC or any of the other series, and vice versa.<sup>231</sup> However, a member or manager will only be held personally liable for the debts and liabilities of one or more series upon agreement between the members of the series.<sup>232</sup> The limitation of liability is only conferred on a series once the mandatory

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221 Bahena 2010:817.

222 For example *GxG Management LL.C. v Young Bros. and Co., Inc.*, 2007 WL 551761 (D.Me.2007); Bahena 2010:818.

223 A fair amount of discretion is placed in the hands of the bankruptcy judge; therefore, results may vary greatly from state to state. See Bahena 2010:818.

224 Powell 2008:109.

225 Bahena 2010:819.

226 Bahena 2010:819.

227 Bahena 2010:819.

228 Bahena 2010:819.

229 Fink 2011:602.

230 Gingerich 2009:209.

231 Dawson 2010:519.

232 Dawson 2010:520.

requirements for its formation have been met in terms of the state law of its organisation. A series created under Delaware law has the “power and capacity to, in its own name, contract, hold title to assets (including real, personal and intangible property), grant liens and security interests, and sue and be sued”.<sup>233</sup> The question that arises is whether a series LLC will be able to file a petition for bankruptcy in its own name.

Both the nature and purpose of the series LLC seem to hinder the application of bankruptcy law within an equitable context. Conaway and Tsoflias<sup>234</sup> submit that a Delaware series LLC will not be able to submit a petition for bankruptcy without statutory authority. The underlying issue concerning the application of bankruptcy law to the series LLC is that of “separateness”, as discussed earlier, but there are also certain practical difficulties associated with the application of bankruptcy law to the series LLC.

## 6.1 The “single asset real estate” entity

The real estate industry seems to derive most benefit from the structure of the series LLC; holding real estate seems to be a quintessential use of the LLC.<sup>235</sup> Many practitioners advocate the use of the series LLC structure to segregate real estate parcels and/or on-site businesses into separate series entities, in order to shield each property and business from liabilities that arise from any of the others.<sup>236</sup> Yet, the use of the series LLC structure in a parallel fashion makes other business entities vulnerable to significant disadvantages in bankruptcy, because each LLC series entity that holds any real estate<sup>237</sup> may be considered a single asset real estate (SARE). The primary disadvantage of SAREs is that a court often dismisses the application filed by a SARE on the basis of bad faith, whether there is bad faith or not.<sup>238</sup> In addition, the notion of a SARE application is not singular, and any merging of two or more series entities will not avoid SARE status.<sup>239</sup> Even enterprises holding multiple properties and on-site operations are at risk of being declared a SARE in a bankruptcy proceeding.<sup>240</sup>

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233 Del. Code. Ann. tit. 6, § 18-215(c) *Delaware Limited Liability Company Act*.

234 Conaway & Tsoflias 2012:39.

235 Blake 2010:20.

236 Blake 2010:20.

237 Blake 2010:21.

238 A court will look at certain factors to determine the dismissal of a SARE bankruptcy, namely whether the debtor has only one asset; whether the debtor has relatively few unsecured creditors whose claims are small compared to those of secured creditors; whether the debtor has few employees; whether the property is the subject of a pending foreclosure and primarily involves a dispute between the debtor and its secured creditors, and whether the debtor's filing was timed to frustrate the legitimate rights and remedies of the secured creditor(s). See Blake 2010:21.

239 Blake 2010:23.

240 Blake 2010:23.

The SARE provisions in the Bankruptcy Code have been amended several times; the *Bankruptcy Abuse Prevention and Consumer Protection Act* of 2005<sup>241</sup> eliminated the ceiling value generally required to consider an enterprise a SARE, and redefined a SARE to broadly include all properties that may be deemed as a single project.<sup>242</sup> Section 101(51B) of the Bankruptcy Code defines a SARE as:

... a single property or project, other than residential real property with fewer than four residential units, which generates substantially all of the gross income of a debtor who is not a family farmer and on which no substantial business is being conducted by a debtor other than the business of operating the real property and activities incidental.<sup>243</sup>

This new definition is all-inclusive and may do more harm than good, as it fails to create a risk profile for companies that hold real estate of significant value, especially when properties are held in segregated series entities. Larger entities are in a position to derive more benefits from the series LLC structure, but smaller entities suffer the tremendous risk of bankruptcy disadvantages due to a lack of adequate assets, management and workforce.<sup>244</sup>

## 6.2 Substantive consolidation

The series LLC may be subject to bankruptcy disadvantage if it is considered a SARE enterprise because of its structure. Admittedly, this disadvantage is not the only hindrance facing the series LLC. The series LLC may also be subject to equitable or substantive consolidation by a bankruptcy court because of its purpose — the limitation of liability of the entities' members and managers. Equitable or substantive consolidation is the legal theory in terms of which a bankruptcy court may satisfy the debts of interrelated entities by treating them as a single entity.<sup>245</sup> The status of the series LLC is, to a large extent, unknown in bankruptcy law, because bankruptcy courts are not bound by state law and are not subject to the

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241 *Bankruptcy Abuse Prevention and Consumer Protection Act*, 11 U.S.C. §§ 101-1502 (2006).

242 Blake 2010:23.

243 "Single asset real estate bankruptcy", <http://definitions.uslegal.com/s/single-asset-real-estate-bankruptcy/> (accessed on 13 August 2013). The definition includes apartment buildings, office buildings and strip-mall shopping centres owned by an entity whose sole purpose is to generate income through the operation of the property and any incidental activities related thereto. See Blake 2010:24.

244 Blake 2010:28.

245 Blake 2010:16. The equitable or substantive consolidation theory serves as an alternative theory that aims to achieve much the same result as other "alter ego" and "veil-piercing" doctrines – doctrines which the Delaware series LLC provisions specifically prohibit.

full faith and credit clause contained in the United States Constitution.<sup>246</sup> Under section 190(a) of the Bankruptcy Code, “only a person that resides or has a domicile, a place of business, or property in the United States, or a municipality, may be a debtor” in bankruptcy.<sup>247</sup> A “person” includes, among other, “an individual, a partnership and a corporation”.<sup>248</sup> The code underwent substantial amendments in 2005, but that revision did not address the inclusion of the LLC, let alone the series LLC.<sup>249</sup>

Initially, a bankruptcy court may be inclined to presume that a series entity is a separate and distinct entity with limited liability, but upon the presentation of evidence proving that ostensibly separate affiliates operate as a single entity, the court may create a single pool of assets and a single body of creditors.<sup>250</sup> Ironically, despite the proper segregation of its assets, the series LLC seems to be a prime target for the consolidation theory,<sup>251</sup> although the factors for the courts’ consideration may not be of equal weight in the case of an ordinary and a series LLC.<sup>252</sup> Nevertheless, the series LLC may face substantive consolidation, especially if the very use of the series structure is held by a court to necessitate substantive consolidation.<sup>253</sup>

### 6.3 Conclusion

Currently, it is uncertain how a bankruptcy court will respond to a petition for bankruptcy filed by a series LLC. By 2013, there still had been no directive on the matter, and thus far, it does not seem that any series has sought bankruptcy protection.<sup>254</sup> Bahena<sup>255</sup> argues that courts are best

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246 Gingerich 2009:209; Blake 2010:17.

247 11 United States Constitution § 109(a) (2006).

248 11 United States Constitution § 101(41).

249 Dawson 2010:521.

250 Blake 2010:17.

251 The application of the consolidation theory will occur after the application of a three-part balancing test to determine whether the benefits of substantive consolidation in a particular case outweigh any potential harm. The utilisation of the test requires the court to determine whether the corporation and its counterparts have blurred their corporate forms; whether the substantive consolidation will remedy the harm caused by the corporation’s disregard for the corporate separateness necessary to benefit the entire corporate body, and what impact the substantive consolidation will have on the creditors who relied on the corporate separateness when agreeing to provide capital. The court will apply the test in conjunction with an analysis of the case-specific facts. See Blake 2010:17.

252 Blake 2010:17-18.

253 Blake 2010:18-19. At 19, Blake states that the contemporary substantive consolidation theory stems from judges’ concern about the increasing use of intricate, asset-protection-based business structures that may depose equity. Thus, a court may discriminate against the series LLC on the basis of its structure and its purpose, especially if creditors lacked appropriate notice of the series’ status as a separate entity with limited liability.

254 Rutledge 2013:72.

255 Bahena 2010:819.

able to protect creditor interests and ensure equitable asset distribution by not allowing a series to file for bankruptcy. Alternatively, if a court does allow a series to file for bankruptcy, it should allow creditors to access the assets of related series as well as the series LLC as a whole.<sup>256</sup> At this point, it is only possible to anticipate the possibilities and consider the developments required to deal with such matters. The series LLC has immense commercial potential, but it is yet to attain legal certainty on certain fundamental matters, particularly matters related to the boundaries of limited liability. Blake<sup>257</sup> argues that additional developments in tax and bankruptcy laws will heighten the performance of the series LLC as a vehicle for investment and innovation.

## 7. Taxation of the series LLC

According to Mertens,<sup>258</sup> “[t]ax law is based on statutory authority”. Taxation is a very important motivational factor when choosing an entity.<sup>259</sup> Legislatures must grant authority for tax agencies to regulate tax, so that taxpayers know what, when and how to pay the taxes they owe.<sup>260</sup> While the issue pertaining to the taxation of the LLC seems to have been settled, there exists much uneasiness about the taxation of the series LLC. The reason for this seems to be the lack of authority as to whether a multi-member series entity that is owned by the majority of a common set of members would be treated as a separate partnership for tax purposes.<sup>261</sup>

Strictly speaking, members of an LLC are not owners, but are deemed to have a vested membership interest in the LLC.<sup>262</sup> As yet, the “check-the-box”, or CTB, regulations issued by the Treasury Department in 1996 do not seem to adequately provide for the taxation classification of a separate series within an LLC.<sup>263</sup> This may very well be a result of the uncertainty concerning the recognition of the series LLC as a separate business entity. The question concerning the taxation of the series LLC must be determined in view of the underlying economic arrangement embodied by the structure as well as with due consideration for the members’ respective interests therein.<sup>264</sup>

A situation may arise where a master LLC wishes to issue multi-member series entities, but also wants to derive the tax benefits of a disregarded entity.<sup>265</sup> If the master LLC elected to be taxed as a partnership, its ability to offset profits and losses among the series entities is eliminated, as each

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256 Bahena 2010:819.

257 Blake 2010:28.

258 Mertens 2009:277.

259 Mertens 2009:284; Fink 2011:601.

260 Mertens 2009:277.

261 Blake 2010:10.

262 Blake 2010:11.

263 Bishop 2009:469.

264 Blake 2010:11.

265 Blake 2010:11.

series will be a separate, taxable partnership and not a disregarded entity.<sup>266</sup> Many commentators and practitioners agree that multi-member series entities ought to be treated as separate tax entities if there is little common ownership.<sup>267</sup> As yet, the United States Internal Revenue Service has not given any indication that it will diverge from the current approach to taxing multi-member business entities as either corporations or partnerships.<sup>268</sup> Until such time, it is submitted that a series LLC that wishes to derive the tax benefits offered by disregarded entities must be structured as the sole member of its series entities.<sup>269</sup> Thus, the members of the master LLC will be able to achieve the effect of direct interests in the series entities by way of allocations in the master LLC's operating agreement.<sup>270</sup>

Despite the CTB requirements, the Internal Revenue Service has not issued any guidance on the tax implications associated with using the series LLC and, with the exception of Illinois state law, also fails to provide any direction on the matter.<sup>271</sup> It is yet to be determined whether the master LLC and its series ought to be taxed as a single entity or as various LLCs. If a master LLC and its series are considered to be one entity, the LLC may net passive income and losses between the many series.<sup>272</sup> Arguably, this approach contradicts the very purpose of the series LLC – to confine the assets and liabilities of a series to that particular series. However, it remains unclear whether a series LLC can be regarded as a separate entity for the purposes of taxation.

With the debate continuing, the uncertainty concerning the taxation of the series LLC seems to relate to the fundamental matters of tax classification, the most uncertain of which appears to be the question surrounding the utilisation of the series LLC.<sup>273</sup> The assumption that a series is a separate legal entity, independent from the LLC under Delaware law, does not determine the treatment of the series as a separate entity for federal tax purposes.<sup>274</sup> Notably, the Illinois LLC statute allows the series LLC to consolidate its operations as a single taxpayer and to work together cooperatively to contract jointly.<sup>275</sup> If the LLC and each of its series have exactly the same ownership and management structure, it

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266 Blake 2010:12.

267 Blake 2010:12. This position is supported with reference to the developments related to the Massachusetts business trust in Delaware, in terms of which the tax court has continually considered each series of a Delaware statutory trust as a separate taxpayer. Since 1984, the Internal Revenue Service has also taken this approach and has generally maintained it in a number of private letter rulings.

268 Blake 2010:13.

269 Blake 2010:13.

270 Blake 2010:13.

271 Mertens 2009:280.

272 Mertens 2009:280.

273 Mertens 2009:283.

274 Bishop 2009:489.

275 805 Ill. Comp. Stat. Ann 180/37-40(b) *Illinois Limited Liability Company Act*.

may unify the series LLC as a single taxpayer, saving time and money on tax preparation.<sup>276</sup>

The classification of a series within a series LLC for federal tax purposes may be done by considering the “association” of the members of the series LLC who have rights in respect of the series.<sup>277</sup> If at least two members are associated with a series, the series would be a separate entity for federal tax purposes; on the other hand, if only one member is associated with such series, the series would be disregarded for federal tax purposes, unless it elects to be treated as an association taxable as a corporation.<sup>278</sup> Alternatively, one may focus on the presence or absence of a commonality of ownership and the business purpose between each series within the series LLC.<sup>279</sup> If there is a high level of commonality of ownership and business purposes, the entire series LLC will be treated as a single entity for federal tax purposes.<sup>280</sup> If, however, there is a low level of commonality of ownership and business purposes, each series within the series LLC that has at least two members associated with it would be treated as a separate entity for federal tax purposes.<sup>281</sup> In effect, commonality of ownership and business purpose may thus serve as a baseline for determining whether a series LLC would be treated as a single entity or multiple entities for federal tax purposes.<sup>282</sup>

In 2008, the Internal Revenue Service released the first federal tax classification rule with regard to a series LLC.<sup>283</sup> In private letter ruling number 200803004, they concluded that a series formed under an unnamed state law would be treated as a separate entity for tax purposes.<sup>284</sup> The ruling considered the tax classification of an open-ended management investment company organised as a series LLC.<sup>285</sup> The beneficial interests in the LLC’s properties were segregated into separate series or portfolios of assets.<sup>286</sup> A portfolio series LLC with one member that does not elect to be taxed as a corporation would be treated as a disregarded entity.<sup>287</sup> Portfolios with multiple owners would be treated as partnerships, unless they elect to be treated as corporations.<sup>288</sup> It is important to note that the ruling relied on the design of the CTB regulations to reach a conclusion on the classification question.<sup>289</sup> Accordingly, the series must be regarded

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276 Mertens 2009:295.

277 Levine & Stahl 2011:4.

278 Levine & Stahl 2011:4.

279 Levine & Stahl 2011:4.

280 Levine & Stahl 2011:4.

281 Levine & Stahl 2011:4.

282 Levine & Stahl 2011:4.

283 Bishop 2009:491.

284 Fink 2011:601; Bishop 2009:491.

285 Bishop 2009:491.

286 Bishop 2009:491.

287 Bishop 2009:491.

288 Bishop 2009:491.

289 Bishop 2009:491.

as a separate, independent, taxable entity under the CTB regulations.<sup>290</sup> Following the release of this private letter ruling, it is expected that more states would be willing to amend their state laws to permit the formation of a series LLC and to provide for its regulation. However, the ruling did not clarify other vital issues such as commonality of ownership or the business purpose of a series.<sup>291</sup>

On 14 September 2010, the Internal Revenue Service issued proposed regulations to address the treatment of a series LLC for federal tax purposes.<sup>292</sup> In these regulations, a “series organization” is defined as a “judicial entity that establishes and maintains, or under which is established and maintained, a series”, including a series LLC and a series partnership as well as other series entities.<sup>293</sup> A “series” is defined as “a segregated group of assets and liabilities that is established pursuant to a series statute by agreement of a series organization”.<sup>294</sup> A “series statute” is defined as a statute of a state or foreign jurisdiction that:

... explicitly provides for the organization or establishment of a series of a juridical person and explicitly permits (1) members or participants of a series organization to have rights, powers, or duties with respect to the series; (2) a series to have separate rights, powers, or duties with respect to specified property or obligations; and (3) the segregation of assets and liabilities such that none of the debts and liabilities of the series organization ... or of any other series of the series organization are enforceable against the assets of a particular series of the series organization.<sup>295</sup>

For federal taxation purposes, the proposed regulations provide that a series be “treated as an entity formed under local law”, irrespective of whether or not it is a juridical person for local law purposes.<sup>296</sup> Thus, if a series is classified as a separate entity for federal tax purposes, it would be subject to the normal rules for tax classification. The series would be a “business entity” and an “eligible entity”.<sup>297</sup> The proposed regulations also provide for annual reporting requirements for the effective federal taxation of a series LLC. However, the regulations seem only to address the taxation of the series LLC in its simplest utilisation.<sup>298</sup> Numerous questions remain unanswered with regard to the taxation of the series LLC. Despite this, however, the issuance of the proposed regulations may assist in making the series LLC more usable.<sup>299</sup>

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290 Bishop 2009:491.

291 Levine & Stahl 2011:2.

292 Series LLCs and Cell Companies, 75 Fed. Reg. 55699 (proposed Sep. 14, 2010); Levine & Stahl 2011:2,10.

293 Levine & Stahl 2011:10.

294 Levine & Stahl 2011:10.

295 Levine & Stahl 2011:10.

296 Levine & Stahl 2011:11.

297 Under § 301.7701-2(a), -3(a) of the regulations; Levine & Stahl 2011:11.

298 Levine & Stahl 2011:15.

299 Levine & Stahl 2011:2.

## 8. Fiduciary duties

One of the most attractive features of LLCs is the possibility of limiting, and even eliminating, fiduciary duties.<sup>300</sup> Currently, Delaware common law is still undecided on the issue of whether default fiduciary duties arise where an operating agreement is silent on the matter.<sup>301</sup> The *Delaware Limited Liability Company Act* explicitly provides for the limitation or elimination of fiduciary duties in the series' operating agreement.<sup>302</sup> It is argued that, as long as the series members act in accordance with the operating agreement, the members are contractually protected for good faith reliance on those provisions and, therefore, liability will not follow.<sup>303</sup> However, this does not imply exculpation for a bad faith breach of the implied duty of good faith and fair dealing.<sup>304</sup>

The wording of the provision contained in the Delaware statute makes it clear that the *Act* places contractual principles above tort-based concepts such as fiduciary duties.<sup>305</sup> The traditional notions of fiduciary duties do not seem to fit into the versatile LLC structure.<sup>306</sup> Given that the Delaware series is contractual in nature, the duty of good faith and fair dealing will attach to the performance and execution of the parties' bargained-for exchange.<sup>307</sup> Thus, despite any silence in the operating agreement with regard to fiduciary duties, no fiduciary duties will attach if the series is maintained as a distinct cell from the master LLC and other series.<sup>308</sup> As a default rule, it is suggested that fiduciary duties do not run with each series and do not cross series borders.<sup>309</sup>

Each series is segregated for virtually all purposes: income, management, assets, liabilities, and business intent.<sup>310</sup> Therefore, it makes sense to assume that the members may manage the series independently, without concern for common-law fiduciary duties.<sup>311</sup> However, the uncertainty in case law on the matter necessitates a cautious approach in the operating agreement to include a statement that all contractual duties and liabilities of each series are expressly limited to each particular series.<sup>312</sup> Such caution is especially required where two or more members are associated with one or more series.<sup>313</sup>

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300 Dawson 2010:518.

301 Conaway & Tsoflias 2012:44.

302 Del. Code. Ann. tit. 6, § 18-1101(c) (2007) *Delaware Limited Liability Company Act*.

303 Conaway & Tsoflias 2012:45.

304 Conaway & Tsoflias 2012:45.

305 Conaway & Tsoflias 2012:45.

306 Conaway & Tsoflias 2012:45. For a discussion on fiduciary duties in a LLC, see Campbell 2009.

307 Conaway & Tsoflias 2012:45.

308 Conaway & Tsoflias 2012:45.

309 Conaway & Tsoflias 2012:46.

310 Conaway & Tsoflias 2012:46.

311 Conaway & Tsoflias 2012:46.

312 Conaway & Tsoflias 2012:46.

313 Conaway & Tsoflias 2012:46.

Finally, on 7 November 2012, the Delaware Supreme Court addressed the long-standing question concerning the default attachment of fiduciary duties in the case of the series LLC.<sup>314</sup> In the matter of *Auriga Capital Corp. et al. v Gatz Properties, LLC*, the Delaware court of chancery held that the manager *in casu* was subject to the implied common-law fiduciary duties imposed by the underlying LLC agreement.<sup>315</sup> On appeal, the Supreme Court upheld the Court of Chancery's interpretation of the LLC agreement, but not its reading of the provisions of the Delaware statute.<sup>316</sup> Instead, with regard to the statute, the Delaware Supreme Court instructed practitioners and courts that the Court of Chancery's opinion<sup>317</sup> was mere dictum with no value as precedent.<sup>318</sup>

Although the finding is a step in the right direction, there is still no judicial guidance on the matter of fiduciary duties enforceable against the managers and members of the series LLC. If anything, the Supreme Court's finding reveals that LLC and series LLC members and managers can best protect their interests and reduce uncertainty by expressly providing for the fiduciary duties and standards of care whereby managers and members will be bound (and not bound) in the underlying LLC agreement.<sup>319</sup> The recent amendment to section 18-1104 of the Delaware statute confirms the default rule, namely that fiduciary duties exist in the case of a Delaware LLC, unless stated otherwise in the LLC agreement.<sup>320</sup>

Thus, contractual specificity and clarity will go a long way towards reducing uncertainty surrounding the scope of the manager and members' implied contractual covenant of good faith and fair dealing.<sup>321</sup> Despite the provision in the Delaware statute that the covenant cannot be eliminated by contract, it is recognised that "the implied covenant has rightly been narrowly interpreted by [the Delaware Supreme Court] to apply only when the express terms of the contract indicate that the parties would have agreed to the obligation had they negotiated the issue".<sup>322</sup>

## 9. Conclusion

The series LLC is growing in popularity. However, its relation to business law remains unresolved in numerous respects.<sup>323</sup> In 2008, the National Conference of Commissioners on Uniform State Laws decided to include

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314 Gordet & Welsh 2012:1.

315 *Auriga Capital Corp. et al. v Gatz Properties, LLC.*, 40 A.3d 839 (Del. Ch. 2012); Gordet & Welsh 2012:1.

316 Gordet & Welsh 2012:1.

317 The Court of Chancery held that "the LLC Act starts with the default that managers of LLCs owe enforceable fiduciary duties". See Gordet & Welsh 2012:1.

318 Gordet & Welsh 2012:1.

319 Gordet & Welsh 2012:2.

320 Weiss 2013.

321 Gordet & Welsh 2012:2.

322 Gordet & Welsh 2012:2.

323 Rutledge 2013:71.

series provisions, which were modelled after the Delaware statute, in the *Uniform Business Trust Act*.<sup>324</sup> This *Act* is the first and only uniform *Act* containing series provisions. Series provisions are no longer considered for any other uniform acts, as the concept is still fraught with problems.<sup>325</sup> The committee was divided on whether it should attempt to improve series LLC law through a uniform act, or whether it should wait for state legislation and common law to bring about development.<sup>326</sup> It is yet to be determined whether the problem lies with the application of the series or its underlying concept.<sup>327</sup>

By 2013, the series LLC had been adopted by twelve states in some or other form, including eight series LLCs, five statutory/business trust acts and one limited partnership act.<sup>328</sup> While very few states have adopted series provisions in their LLC legislation, several states have adopted legislation regulating the adjudication of foreign series LLCs operating within their borders.<sup>329</sup> The formation of a series LLC bears the risk that other states will not recognise the limited liability of a series. These limitations also affect the degree to which investors can expand their business, and leave investors and attorneys flying blind in respect of the risks, regulation, taxation, and adjudication of the series LLC.<sup>330</sup> In addition, the relationship between the master LLC and any of its series may be subject to veil-piercing issues. If either the master LLC or any of its series fails to meet any of the requirements for limited liability, both will forfeit the entire shield created to protect the entity against veil piercing.<sup>331</sup> The lack of litigation addressing these issues creates uncertainty with regard to the application and recognition of the series LLC, although there appears to be increasing certainty about upholding the series LLC as a functional single entity.<sup>332</sup>

A substantial amount of legal development is required before there will be certainty in respect of the application and regulation of the series LLC. Until such time, Mertens<sup>333</sup> submits that it would prove more beneficial for an entity to utilise multiple LLCs rather than the series LLC. First, to be effective, series LLC statutes need to make specific provision for all the rights of each series as well as the rights reserved for the master LLC.<sup>334</sup> Secondly, these statutes must provide a default rule for the amount of “separateness” between the master LLC and each series, to provide

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324 *Uniform Statutory Trust Entity Act*, Prefatory Note 2 (Annual Meeting Draft 2008). [http://www.law.upenn.edu/bll/archives/ulc/ubta/2008\\_amdrafthtm](http://www.law.upenn.edu/bll/archives/ulc/ubta/2008_amdrafthtm) (accessed on 26 October 2014); Mertens 2009:305.

325 Mertens 2009:305.

326 Mertens 2009:306.

327 Mertens 2009:306.

328 Rutledge 2013:71.

329 Mertens 2009:289.

330 Mertens 2009:289.

331 Mertens 2009:290.

332 Gingerich 2009:210.

333 Mertens 2009:312.

334 Mertens 2009:312.

guidance not only to the owners, but also to civil and bankruptcy courts.<sup>335</sup> The distance between each series and its master may help to determine the tax implications and piercing ability of each. Finally, series statutes ought to provide for notice of the limited liability of each series to creditors of the LLC, by utilising filing requirements similar to the prerequisites set out in the Illinois statute.<sup>336</sup> Admittedly, until the series LLC is used more often in practice, the likelihood of clarifying the legal position in respect of these concerns remains small.<sup>337</sup>

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335 Mertens 2009:312.

336 Mertens 2009:312.

337 Gingerich 2009:187.

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