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GUIDEPOST

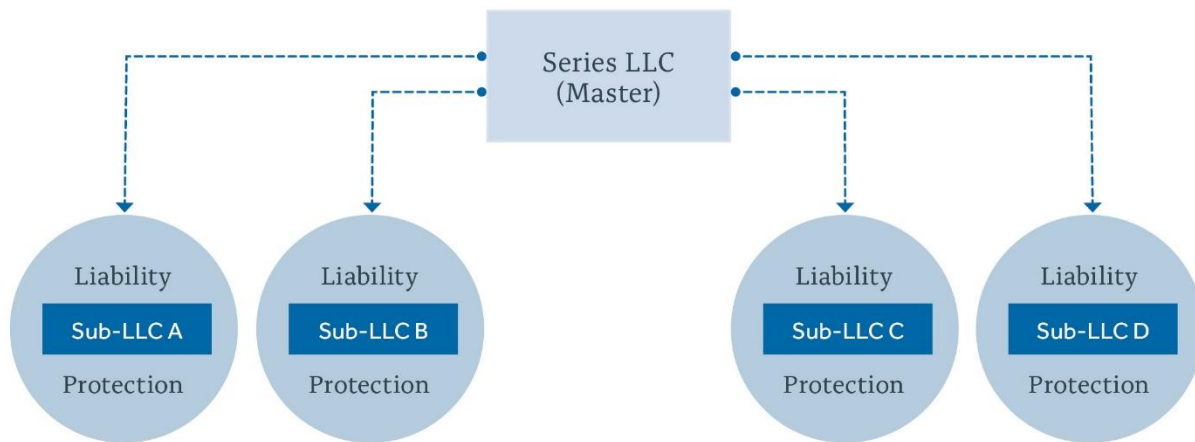
Series Limited Liability Company



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A Series Limited Liability Company (Series LLC) is a form of entity that allows a single “master” LLC to partition its assets and liabilities among various cells known as Sub-LLCs. Each Sub-LLC may have different assets, operations, and/or investment objectives, and the members and managers, as well as their rights, obligations, and their sharing ratios, may be varied. The profits, losses, and liabilities of each Sub-LLC are legally separate from the other Sub-LLCs, which provides a liability shield between each Sub-LLC and the Series LLC. The Series LLC effectively creates a Parent/Subsidiary structure without requiring the administrative complexity and cost of creating and managing multiple LLCs; the structure is similar to that of an S corporation with a Qualified Subchapter S Subsidiary (known as a QSUB).

A Series LLC may be appropriate where a business has a variety of assets or operations that would benefit from liability protection from each other, or where multiple owners have different interests in the business or in different parts of the business operations. A Series LLC may be appropriate in various situations, such as: real estate development; oil and gas exploration; professional businesses; artists and musicians, manufacturing and distribution; hedge funds and private equity; or franchise businesses.



The potential benefits of a Series LLC include reduced administrative costs and fewer state filings, liability protection for each Sub-LLC and the Series LLC, and the ease of adding or terminating individual Sub-LLCs. Additionally, distributions can be made from any Sub-LLC, and each Sub-LLC may have a different sharing ratio. Further, the test of whether sufficient assets exist to permit a distribution is applied at the Sub-LLC level without regard to the financial condition of the other Sub-LLCs or the Series LLC; therefore, a specific Sub-LLC may be able to make a distribution when another Sub-LLC, or even the Series LLC itself, is not able to do so.

Description and Operation

Series LLC legislation has been enacted in 23 states and U.S. territories. Delaware enacted the first Series LLC statute in 1996, and since then has been followed by Wisconsin (2001), Illinois (2005), Iowa (2005), Nevada (2005), Oklahoma (2005), Tennessee (2005), Utah (2006), Texas (2009), Montana (2011), Kansas (2012), Missouri (2013), District of Columbia (2014), Alabama (2015), Indiana (2016), Puerto Rico (2018), Wyoming (2018), Arkansas (2019), Indiana (2019), Nebraska (2019), North Dakota (2019), Virginia (2020), and Ohio (2022). Also, while California has not authorized Series LLCs by statute, California does allow Series LLCs that were formed in other states to register as a foreign entity and do business in California.

While each state has different requirements for establishing a Series LLC, as well as differing degrees of liability shield between sub-LLCs, typically the statutes require:

- The LLC agreement must establish or provide for the establishment of Sub-LLCs;
- The assets of each Sub-LLC must be separately recorded and maintained;
- The LLC agreement must contain language that contemplates the Sub-LLCs and establishes the segregation and distinctness of managers, members, assets, liabilities, and obligations of each series; and
- The LLC's certificate of formation must contain notice of the liability limitations.

The various statutes generally permit each Sub-LLC to hold property, sue and be sued, enter into contracts, and generally conduct business operations for the Sub-LLCs' objectives. Typically, a Sub-LLC may be terminated without affecting the Series LLC or any other Sub-LLCs, which permits businesses to enter and exit new lines or operations without affecting the remainder of the Series LLC.

Proposed Regulations

Income Tax Considerations

In September 2010, the Internal Revenue Service published proposed Treasury Regulation §301.7701-1(a)(5), which provides the following guidance regarding Series LLCs:

- Each Sub-LLC will be treated as a separate entity for federal income tax purposes, regardless of its state law status.
- The tax status of each Sub-LLC would then be determined under the "check-the-box" regulations, which permits each Sub-LLC within the Series LLC to have a separate status for federal income tax purposes. For example, a Sub-LLC with a single member associated will be treated as a disregarded entity, but a Sub-LLC with two or more members will be treated as a partnership (or as a corporation, if elected).
- For federal income tax purposes, the ownership of interests in the Series LLC, and the ownership of the assets associated with a Sub-LLC, is determined under general tax principles. For example, the Series LLC will not be treated as the owner of assets merely because it holds the legal title to such assets. Rather, the ownership depends on who has the economic benefits and bears the burdens of the assets.

The proposed Treasury Regulation does contain a "Grandfather Rule" for Series LLCs established prior to September 14, 2010, which provides that if all Sub-LLCs have been treated as one entity, then such Sub-LLCs may continue that treatment. This status, however, is lost if on or after September 14, 2010 persons who were not owners prior to that date own 50% or greater of the Series LLC.

This Regulation was anticipated to become effective by 2012, but as of January 2021 still has not been finalized.

State Income Tax Considerations

There is limited guidance on state income taxation of Series LLCs. Most states whose income taxes conform to federal tax law are expected to adopt treatment as set forth in proposed regulations, but there is no certainty on this topic. States that impose entity level taxation are also likely to embrace separate entity taxation. For example, California's Franchise Tax Board has taken the position that it will tax income from those sub-LLCs conducting business in California but that each Sub-LLC will be responsible for the annual franchise tax; and Texas' Office of the Comptroller has issued informal advice that it will treat each Sub-LLC of a Series LLC separately.

Employment Tax Considerations

The proposed Treasury Regulation referenced previously addresses how the Series LLC will be treated for federal income tax purposes but is silent with regard to how it would be treated for federal employment tax purposes, and thus remains a point of uncertainty regarding Series LLCs.

Insights and Concerns

The Series LLC is a new type of entity that has not yet been widely adopted, and that will likely present unique issues and planning challenges. The largest potential challenge to the Series LLC is whether the internal liability protections will be respected by bankruptcy courts and courts in states that have not enacted Series LLC legislation. Additionally, there is a lack of uniformity in the legislation among the states that have authorized Series LLCs, which may impact the protection afforded a Series LLC formed in one state if it is operating in another state. It may be advisable to limit Series LLCs to businesses that operate solely in states that have enacted such legislation.

The Series LLC may also be more susceptible to potential veil-piercing arguments and may necessitate greater adherence with administrative formalities to ensure that the entity is not disregarded. Similarly, Series LLCs may be more susceptible to application of the “substantive consolidation” doctrine, which is a doctrine permitting bankruptcy courts to collapse multiple legal entities where it appears such multiple entities operate more akin to a single entity. The risk of substantive consolidation may be reduced by adhering to the proper formalities in operating each Sub-LLC separately, such as maintaining separate books of account, recording separate meetings of members, and avoiding commingling of assets.

Uniform Series LLC Act

The inconsistency in recognition and treatment of Series LLCs across the U.S. supports the need for uniform legislation. It has been over 20 years since Delaware first authorized Series LLCs, and in that time less than half the states have adopted similar legislation. By contrast, within 20 years of Wyoming introducing the nation to the LLC, all 50 states had adopted LLC legislation.

In 2012, the National Conference of Commissioners on Uniform State Laws (NCCUSL) assembled a committee to address the need for uniform Series LLC legislation, and the committee published several drafts. Since then, the committee has released and revised several drafts, culminating on July 19, 2017, with approval by the Uniform Law Commission (ULC) at its annual meeting of the Uniform Limited Liability Company Protected Series Act (ULLCPSA). The major changes that lead to approval appear to be increasing transparency to the public, increasing protections for consumers and creditors, and increasing control over protected series from foreign jurisdictions. The uniform act addresses the following key points:

- **Filing Requirement.** The uniform act requires that a separate public filing establish each protected series in a Series LLC. Most existing Series LLC statutes (with the notable exception of Illinois) do not require separate filings for each protected series. Requiring separate filings will increase transparency to the public. Separate filings may also increase the cost of forming and operating a Series LLC.
- **Associated Members.** The uniform act provides that a person must be a member of the Series LLC in order to be an associated member of any protected series. The act does not, however, describe how a person becomes an associated member, but rather leaves that determination to the governing operating agreement. Further, the uniform act addresses certain rights of associated members, such as veto rights to operating agreement amendments affecting the protected series, transferability of interests, and management rights.
- **Recordkeeping.** The uniform act outlines special recordkeeping requirements that apply to transfers between a Series LLC and a protected series of the company and to transfers between protected series of the company. Existing state Series LLC statutes do not provide this level of detail, resulting in confusion and open questions. The emphasis on recordkeeping is a theme in this uniform act, reflecting the committee’s desire to prevent Series LLCs from being used as a shell entity.
- **Veil Piercing.** The uniform act specifies rules for disregarding the internal liability shields that protect the assets of one protected series from the creditors of another. Other than a general recordkeeping requirement, most existing Series LLC acts provide no guidance on maintaining limited liability among the protected series.
- **Non-Associated Assets.** The uniform act provides asset-by-asset consequences for assets not properly associated with a protected series, even if the internal shields among series remain in place. Notwithstanding the limited liability in place among the protected series, this means certain assets are up for grabs from creditors if they are not owned

by a given protected series or they are not properly tracked via the protected series recordkeeping procedures. The uniform act also makes clear that non-associated assets cannot be associated after a claim against the asset has been made.

- **Foreign Protected Series.** The uniform act provides that protected series must register to do business in any state outside the state in which it was established. The foreign protected series must also satisfy the same name and disclosure requirements that domestic protected series are subject to. Also, the uniform act further permits a court to use an enacting state's veil piercing law on foreign protected series if the foreign state's law is repugnant to the public policy of the enacting state.

Legislative passage will be the next step for the ULLCPSA. Some of the requirements of the ULLCPSA, such as registration of each protected series and copious record-keeping, may discourage business owners from using this form of entity if they determine that the expense and administrative burdens are prohibitive. Planning professionals, however, may experience an increase in clients' interest in Series LLCs as the entity ages and gains acceptance. Prudence suggests adherence to structures involving several limited liability companies to establish the legal and business relationships otherwise made possible using a Series LLC, at least until the uniform act is widely adopted.

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