

# Series LLCs: A Wave of the Future – Or Not?

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By Vicki R. Harding

Fifteen to twenty years ago, the limited liability company (LLC) emerged as a viable new type of entity. It combined the corporate concept of limited liability with the partnership concept of pass-through taxation. And it brought a new vocabulary of “members” and “managers” instead of officers, directors, and partners, and “articles of organization” (or “certificate of formation” in Delaware) and “operating agreement” (or “limited liability company agreement” in Delaware) in place of articles of incorporation, bylaws, and partnership certificates and agreements. Initially, as a practical matter lawyers hesitated to use LLCs for activities in states that had not adopted an LLC statute due to uncertainty about the treatment of LLCs in those states (particularly whether an LLC’s liability shield would be respected). Today, however, every state has adopted an LLC statute, and limited liability companies have become a common form of organization for business entities.

## Delaware LLC Series as Super Division or Mini-LLC

Recently the “series limited liability company” (series LLC) has appeared on the horizon as an alternative to traditional LLCs. The natural inclination is to expect a series LLC to be analogous to corporate series of stock. So it is not surprising to see that the series LLC provision in the Delaware Limited Liability Company Act<sup>1</sup> begins with the concept of classes of ownership similar to a class or series of stock:

A limited liability company agreement may establish or provide for the establishment of 1 or more designated series of members, managers or limited liability company interests having separate rights, powers or duties with respect to specified property or obligations of the limited liability company or profits and losses associated with specified property or obligations, and any such series may have a separate business purpose or investment objective.<sup>2</sup>

However, the series LLC as it has evolved in Delaware has been extended to include features that are similar to the corporate concept of a division in that a series may be formed with respect to only a portion of the business enterprise (*e.g.*, “specified property or obligations of the limited liability company”) but which go beyond the division concept in that the assets of a series established within the LLC may be protected from liabilities of other series and of the LLC itself (unlike a division, which has no status as a segregated entity within a corporation for purposes of creditors of the corporation, including its divisions):

Notwithstanding anything to the contrary set forth in this chapter or under other applicable law, in the event that a limited liability company agreement establishes or provides for the establishment of 1 or more series, and if separate and distinct records are maintained for any such series and the assets associated with any such series are held in such separate and distinct records (directly or indirectly, including through a nominee or otherwise) and accounted for in such separate and distinct records separately from the other assets of the limited liability company, or any other series thereof, and if the limited liability company agreement so provides, and if notice of the limitation on liabilities of a series as referenced in this subsection is set forth in the certificate of formation of the limited liability company, then the debts, liabilities, obligations and expenses incurred, contracted for or otherwise existing with respect to a particular series shall be enforceable against the assets of such series only, and not against the assets of the limited liability company generally or any other series thereof, and, unless otherwise provided in the limited liability company agreement, none of the debts, liabilities, obligations and

expenses incurred, contracted for or otherwise existing with respect to the limited liability company generally or any other series thereof shall be enforceable against the assets of such series.<sup>3</sup>

In other words, under the Delaware LLC Act it is possible to establish multiple “series” within a single limited liability company that function in virtually all respects as though they were separate LLCs.

### Series LLC Legislation in Other States

Interest in the concept of an LLC series as a kind of super division or mini-LLC within the LLC is not limited to Delaware. States that have adopted this type of LLC series legislation include Illinois,<sup>4</sup> Iowa,<sup>5</sup> Nevada,<sup>6</sup> Oklahoma,<sup>7</sup> Tennessee,<sup>8</sup> and Utah.<sup>9</sup> Although generally the statutes are very similar, Illinois includes variations that may become important if the popularity of series LLCs continues to grow.

Under the Delaware LLC Act, the internal liability shield for a series is available only if notice of the limitation on liabilities of a series is included in the certificate of formation of the LLC. However, this requires only a general notice, not notice of a specific series:

Notice in a certificate of formation of the limitation on liabilities of a series as referenced in this subsection shall be sufficient for all purposes of this subsection whether or not the limited liability company has established any series when such notice is included in the certificate of formation, and there shall be no requirement that any specific series of the limited liability company be referenced in such notice. The fact that a certificate of formation that contains the foregoing notice of the limitation on liabilities of a series is on file in the office of the Secretary of State shall constitute notice of such limitation on liabilities of a series.<sup>10</sup>

In contrast, limitation on series liability is available in Illinois only “if the operating agreement so provides, and notice of the limitation on liabilities of a series as referenced in this subsection is set forth in the articles of organization of the limited liability company and if the limited liability company has filed a certificate of designation for each series which is to have limited liability under this Section.”<sup>11</sup>

(Note that under the Illinois statute, a foreign LLC or series qualifying to do business in Illinois must also file a certificate of designation for each series that is qualifying.)<sup>12</sup>

The Illinois statute also includes additional language that specifically addresses certain aspects of how a series functions and appears to limit the ability of a series to operate independently to those that have qualified for limited liability:

The fact that the articles of organization contain the foregoing notice of the limitation on liabilities of a series and a certificate of designation for a series is on file in the Office of the Secretary of State shall constitute notice of such limitation on liabilities of a series. A series *with limited liability* shall be treated as a separate entity to the extent set forth in the articles of organization. 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 under this Act. The limited liability company and any of its series may elect to consolidate their operations as a single taxpayer to the extent permitted under applicable law, elect to work cooperatively, elect to contract jointly or elect to be treated as a single business for purposes of qualification to do business in this or any other state. Such elections shall not affect the limitation of liability set forth in this Section except to the extent that the series have specifically accepted joint liability by contract.<sup>13</sup>

Thus, to the extent that development of series LLCs diverges in Illinois, it will be important to keep in mind the variations in its underlying statute.

### Is a Series Always a Series?

Given the generally similar approach adopted in the statutes identified above, one might expect to find a general understanding of what is meant by a reference to a “series” in an LLC. However, the natural confusion that arises from using a term that has a different meaning in the context of corporations is exacerbated by the fact that some states have used the term “series” in their LLC acts so that it has the same meaning as in the corpo-

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ration context. In other words, a series may have special voting or distribution rights, but there is only a single business entity.

For example, the Minnesota<sup>14</sup> and North Dakota<sup>15</sup> LLC statutes have the following definitions of “class” and “series”:

“Class,” when used with reference to membership interests, means a category of membership interests which differs in one or more rights or preferences from another category of membership interests of the limited liability company.

...

“Series” means a category of membership interests, within a class of membership interests, that has some of the same rights and preferences as other membership interests within the same class, but that differ in one or more rights and preferences from another category of membership interests within that class.

Similarly, the Wisconsin LLC statute includes the following:

An operating agreement may establish, or provide for the establishment of, designated series or classes of members, managers, or limited liability company interests that have separate or different preferences, limitations, rights, or duties, with respect to profits, losses, distributions, voting, property, or other incidents associated with the limited liability company.<sup>16</sup>

Given this context, a passing reference to a “series” of interests in a state’s LLC statute should not be read to incorporate the evolving concept of a super division or mini-LLC as adopted in detailed provisions of the Delaware, Illinois, and other state statutes. (Note that the Michigan Limited Liability Company Act does not include any series LLC provisions, nor does it include any reference to a series of interests.)

### Rejection of Series LLCs by NCCUSL

Notwithstanding the significant interest in series LLCs as evidenced by state legislative activity, many remain skeptical about the value of this structure. The issue was raised in connection with the Revised Uniform Limited Liability Company Act that was approved by the National Conference of Commissioners on Uniform State Laws in July 2006.

The drafting committee considered the issue, and the concept had strong support from some members, but ultimately it was rejected. The prefatory note to the Revised Uniform Limited Liability Company Act provides a good summary of concerns that have been expressed about use of series LLCs:

[A] number of difficult and substantial questions remain unanswered, including:

- *Conceptual* – How can a series be – and expect to be treated as – a separate legal person for liability and other purposes if the series is defined as part of another legal person?
- *Bankruptcy* – Bankruptcy law has not recognized the series as a separate legal person. If a series becomes insolvent, will the entire LLC and the other series become part of the bankruptcy proceedings? Will a bankruptcy court consolidate the assets and liabilities of the separate series?
- *Efficacy of the internal shields in the courts of other states* – Will the internal shields be respected in the courts of states whose LLC statutes do not recognize series? Most LLC statutes provide that “foreign law governs” the liability of members of a foreign LLC. However, those provisions do not apply to the series question, because those provisions pertain to the liability of a member for the obligations of the LLC. For a series LLC, the pivotal question is entirely different – namely, whether some assets of an LLC should be immune from some of the creditors of the LLC.
- *Tax treatment* – Will the IRS and the states treat each series separately? Will separate returns be filed? May one series “check the box” for corporate tax classification and the others not?
- *Securities law* – Given the paucity of unanswered questions, what types of disclosures must be made when a membership interest is subject to securities law?

...Given the availability of well-established alternate structures (e.g.,

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multiple single member LLCs, an LLC “holding company” with LLC subsidiaries), it made no sense for the Act to endorse the complexities and risks of a series approach.<sup>17</sup>

### Series LLC in Michigan (or Other States Without Statutory Series Provisions)?

To the extent that isolating the assets of a series from non-series liabilities is an important goal, there is a significant risk that a series LLC will not be effective to provide the desired liability shield in any state other than a state that expressly recognizes that concept.

The Michigan Limited Liability Company Act provides that “the laws of the jurisdiction under which a foreign limited liability company is organized shall govern its organization and internal affairs.”<sup>18</sup> However, the Act also provides that a foreign LLC holding a certificate of authority “has no greater rights or privileges than a domestic limited liability company.”<sup>19</sup> This language, which is typical of language found in other LLC acts, suggests that it is likely that limitations on series liability will be enforceable among managers and members of the LLC and each series, while it is questionable that the limitations will be binding on third-party creditors.

On the practical side, it will be difficult to qualify a foreign series LLC in Michigan so that the series status is officially recognized. A Delaware series LLC is formed by filing its certificate of formation with the Delaware Secretary of State. Although the certificate of formation must disclose the possibility that one or more series may be created with limited liabilities, no filing is required (or contemplated) in connection with establishing a series.

Thus, although it is now possible to obtain a good standing certificate from Delaware that identifies that an LLC is a series LLC (*i.e.*, the certificate of formation includes a statement about limitations on series liability), the good standing certificate is for the LLC entity itself and not for an individual series. Consequently, the application of a Delaware series LLC for a certificate of authority to do business in Michigan (which requires attachment of a good standing certificate) will necessarily relate to the LLC itself and not to any individual series.

One alternative may be to form the series LLC under the Illinois statute. As a result of

the requirement that each series file a certificate of designation, the secretary of state maintains records regarding the status of each series as well as the LLC itself and will issue a good standing certificate for a specific series. (Examples of Illinois state forms of Articles of Organization for a series LLC (Form LLC-5.5(S)), Certificate of Designation for a series (Form LLC-27.40), and Application for Admission to Transact Business for a foreign series LLC (Form LLC-45.5(S)) are available through the Illinois secretary of state’s Web site) at [http://www.cyberdriveillinois.com/departments/business\\_services/publications\\_and\\_forms/llc.html](http://www.cyberdriveillinois.com/departments/business_services/publications_and_forms/llc.html).<sup>20</sup>

### Why a Series LLC?

There may be circumstances where a series LLC is useful. For example, for regulatory reasons, a bank wanted to use an entity licensed by the U.S. Small Business Administration (SBA) as a small business investment company (SBIC) to make venture capital investments. The bank intended to do a series of \$25 million funds to be invested by the management team, with incentive compensation tied to the performance of each \$25 million fund. At the time the bank was evaluating its options, the SBA was typically taking at least nine months to issue an SBIC license.

Rather than form multiple entities, each of which was required to go through the entire licensing process, the SBA accepted the bank’s proposal and licensed a single series limited partnership<sup>21</sup> with a single series LLC as the general partner, permitting the bank to create a separate series of the partnership and the general partner LLC for purposes of investing each \$25 million fund. This solved the problem of a licensing delay and, as an added benefit, simplified documentation of the subsequent funds (since each fund was created by execution of a short supplement that identified fund specific information, such as the identity of the managers, the members, and their capital commitments).

Series LLCs appear to have their origins in the world of investment funds, which maintain separate portfolios of investments under the umbrella of a single entity, and a Delaware series LLC provides a convenient legal structure designed to accommodate that result.

However, attempts to apply this template in other contexts must be tempered with a recognition of the practical and legal differences between an investment fund and other

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circumstances. For example, a structure that is used in connection with operating assets (such as multiple commercial projects) is likely to require more robust liability limitations than a fund holding equity securities. Similarly, use of a series LLC based on a desire to simplify documentation and reduce filing fees and taxes may be misplaced either because of the complexities inherent in a series LLC or because of unfavorable developments in the treatment of series LLCs as they become more prevalent.

It remains to be seen whether the series LLC will become the new entity of choice, or whether it will be the right alternative in only limited circumstances.



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## NOTES

1. 6 Del Code 18-215.
2. 6 Del Code 18-215(a).
3. 6 Del Code 18-215(b).
4. 805 ILCS 180/37-40.
5. Iowa Code 490A.305.
6. NRS 86.296.
7. 18 Okl St 2054.4.
8. Tenn Code Ann 48-249-309.
9. Utah Code Ann 48-2c-606.
10. 6 Del Code 18-215(b).
11. 805 ILCS 180/37-40(b) (emphasis added).
12. 805 ILCS 180/37-40(o).
13. 805 ILCS 180/37-40(b) (emphasis added).
14. Minn Stat Ann 322B.03.
15. NDCC 10-32-02.
16. Wis Stat Ann 183.0504.
17. [http://www.law.upenn.edu/bll/ulc/ullca/2006act\\_final.htm#\\_Toc147562675](http://www.law.upenn.edu/bll/ulc/ullca/2006act_final.htm#_Toc147562675).
18. MCL 450.5001.
19. MCL 450.5003(3).
20. Illinois Secretary of State.
21. Delaware authorizes formation of series limited partnerships in addition to series limited liability companies.