THE EMERGING USE OF SERIES LLCs FOR REAL ESTATE HOLDINGS AND VENTURES: OPPORTUNITIES AND UNCERTAINTIES

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I. INTRODUCTION

Traditionally, limited partnerships were the entity choice for real estate and similar financing ventures.¹ During the past decade, limited liability companies (LLCs) have become the choice of entity for many types of businesses, including real estate enterprises. When Wyoming enacted the first LLC statute in 1977,² it seemed unlikely at the time that ten years later every state would enact LLC statutes and LLCs would become such a widely used entity. The key event that led to LLCs becoming the favored entity among practitioners was clearly the issuance by the IRS of the check-the-box regulations.³ Prior to those regulations, practitioners were concerned about how an LLC would be taxed for federal purposes and, thus, were reluctant to set up LLCs. That has changed dramatically since the check-the-box regulations.

LLCs provide limited liability to LLC members,⁴ much like a corporation, and also allow great flexibility in organization, management, and federal taxation, much like a partnership. Real estate investors and entrepreneurs have turned away from using general or limited partnerships for real estate ventures and increasingly use LLCs because an LLC provides pass-through tax deductions⁵ without the unlimited liability risks that are inherent with general partnerships. In addition, two recent federal court decisions have provided additional incentives for using an LLC instead of a limited partnership.⁶

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¹ See generally Thomas E. Rutledge, The Alphabet Soup of Unincorporated Business Law: What is Happening With LLCs, LLPs, GPs, LLPs, & BTs and Dealing With RUPA, (Re)ULPA, RULLCA, UnETA, MTA, & META (ALI-ABA Feb. 4, 2009). See also John L. Davidson, Observations of Financing of Real Estate Construction, S.C. LAW., Jan. 2005, at 39 (stating that use of new “devices” such as “series LLCs” should be monitored for their application to real estate ventures).


³ Treas. Reg. § 301.7701 (1996). On December 17, 1996, the IRS and the Treasury Department issued new Code 7701 regulations for determining the tax status of business entities. These “check-the-box” regulations, effective January 1, 1997, rescinded the complex requirements that had been imposed on LLCs seeking to be taxed as partnerships for federal income tax purposes. Under the final “check-the-box” regulations, domestic LLCs and other business entities that are not corporations may be automatically treated as partnerships for tax purposes if they have two or more owners, or will be disregarded for tax purposes if they have only one owner. However, single-member and multi-member LLCs may affirmatively elect to be treated as an association (C corporation or S corporation).

⁴ A creditor’s claim against an LLC is limited to the assets of the LLC, and LLC members and managers are not personally liable for the debts, obligations, or liabilities of the LLC solely by reason of being a member or manager. Generally, members are only liable for LLC obligations up to the amount of their contribution to the LLC. However, (1) an LLC member is liable for commitments to contribute additional capital to the LLC and for any wrongful distributions from the LLC as well as the member’s own wrongdoing or negligence, or any debts that the member personally guarantees; and (2) an LLC member may also be personally liable if the LLC veil is pierced and it is held that the LLC is nothing more than the alter-ego of the member(s). See, e.g., Del. Code tit. 6, §§ 18-303(a), -502(a), -804(c) (2009).

⁵ See supra note 2.

⁶ See infra text accompanying note 40.
To achieve greater liability protection, most legal practitioners recommend that their real estate clients place each parcel of real estate or real estate project into a separate LLC. With a growing number of states enacting series LLC statutes, a real estate venture may form a single LLC and then create a number of “series” within that LLC, with each series containing a separate parcel of real estate or part of the real estate venture. Because series LLCs are relatively new (outside of Delaware) and only a handful of states have enacted “full” series LLC statutes, practitioners are divided on whether it is appropriate to use series LLCs. Although series LLCs are ideally suited for real estate ventures, there are practical concerns about their use because of key unknowns—federal taxation, judicial respect for the liability shield protecting the assets in each series from claims against other series and from the LLC itself, bankruptcy, and how states without series statutes will treat foreign series LLCs.

Series LLCs are the ideal entity choice for real estate holdings and ventures. Just as LLCs have replaced limited partnerships as the entity of choice for real estate enterprises, series LLCs will eventually be used in real estate as much as LLCs are today. However, series LLCs are relatively new entities that are not available to entrepreneurs in every state. There are also many unanswered legal and tax questions involving series LLCs. Courts and the IRS are just beginning to resolve some of these uncertainties. As courts, state legislatures and the IRS provide practitioners with consistent legal interpretations and guidance regarding series LLCs, many new real estate ventures, as well as existing ones, will opt to use series LLCs and avail themselves of the significant benefits that series LLCs offer real estate entrepreneurs and property owners.

This article will: (1) provide an overview of LLCs, focusing on the characteristics that distinguish them and make them unique from other business entities; (2) discuss the reasons that LLCs have become the entity of choice for real estate ventures; (3) explain the history and development of series LLCs, including a discussion of the recent trend among states to enact series LLC legislation and/or recognize out-of-state series LLCs; (4) analyze the potential benefits and risks with using series LLCs for real estate ventures; and (5) use practical examples and analysis to highlight some of these concerns.

II. LLCs

All fifty states and the District of Columbia have enacted LLC statutes and allow both multi-member and single-member LLCs. In addition, these laws recognize LLCs formed in other jurisdictions (“foreign LLCs”) and govern their obligations and protections as they conduct business within the state.7

Only a handful of states have adopted either of the Model Uniform LLC Acts.8 Although the basic attributes of an LLC are fairly standard among these

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8 As of 2008, the ULLCA (1996) was adopted in only Alabama, Hawaii, Illinois, Montana, South Carolina, Vermont, the U.S. Virgin Islands, and West Virginia, and there were still variations from the full text of the ULLCA.
various jurisdictions, there are some significant differences as well. LLC organizers accordingly look to form LLCs in states with the “most favorable” LLC statutes, just as many corporations choose Delaware as the state of incorporation because of its reputation for having a pro-business climate.9

All LLC statutes provide for limited liability to LLC members and grant a great deal of latitude to LLC members to organize and conduct their business affairs based on contract principles, unlike corporations and limited partnerships, which are subject to rigid state laws.10 All jurisdictions provide for particular tax treatment of LLCs and, with a few exceptions, the state tax treatment follows the federal tax treatment of LLCs.11

Now that all states have LLC statutes, LLCs can operate in multiple jurisdictions with confidence in how each state will treat them. This consistent treatment, coupled with favorable federal tax policy under the check-the-box rule, has resulted in LLCs’ becoming the entity of choice for many types of business (and nonbusiness) ventures.

LLCs are now widely used in almost every jurisdiction, but it did not happen overnight. Practitioners were cautious in recommending that clients form an LLC until some of the early unknowns were resolved. Based on these same concerns, practitioners remain reluctant to recommend that clients use of series LLCs, to clients, except in limited situations.

III. LLCs ARE THE NEW ENTITY OF CHOICE IN REAL ESTATE: FACTORS TO CONSIDER IN CHOOSING A REAL ESTATE ENTITY

LLCs are now a widely used entity for real estate owners and real estate ventures.12 The two primary factors usually considered in making a business entity choice, especially for closely held businesses, are limiting the owners’ liability risk and obtaining the most favorable tax treatment for the entity and/or the owners. The following discussion will cover some of the key issues that should be considered in deciding which entity is best suited to a particular real estate project.

9 See, e.g., Charles R. Levun, The Delaware Series LLC: Sometimes a No-Lose Alternative, CCH’S PARTNERSHIP TAX PLANNING & PRACTICE, Apr. 26, 2004 (most professionals view Delaware “at the forefront of entity governance”).
10 See, e.g., Del. Code tit. 6, § 18-1101(c) (2009), in which Delaware was the first state to allow LLCs to limit and define fiduciary duties for members, managers and other persons who might normally have fiduciary and other duties to each other and to the LLC. Delaware law provides that a member’s or manager’s or other person’s duties may be expanded, restricted, or eliminated by provisions in the LLC agreement. However, the LLC agreement may not eliminate the implied contractual covenant of good faith and fair dealing. Because the implied covenant of good faith and fair dealing is really an obligation that is contractual in nature, in effect, Delaware has allowed LLC agreements to eliminate all fiduciary duties.11 See, e.g., Del. Code, tit. 6, § 18-1107 (2009).
12 See generally James Kehl, Allocating Losses of LLCs Engaged in Real Estate Activities, CCH’S J. OF PASSTHROUGH ENTITIES, May-June 2004, at 35.
In a general partnership, all the partners (owners) are personally liable for the debts of the partnership. In a limited partnership, the limited partners are not liable for the debts of the partnership (beyond the amount that they contributed to the limited partnership), but the general partner is personally liable for the partnership debts. In a corporation (either C or S) the shareholders are not personally liable for the corporate debts and obligations. LLC members (who are its owners) are in a similar position to shareholders in that they are not personally liable for the LLC’s debts and obligations.13

A C corporation and its shareholders are subject to a double level of taxation—first at the corporate level and then again at the shareholder level. S corporations and partnerships are treated as pass-through entities, and thus the entity does not pay tax on its earnings; instead, the partners or members recognize the gain or loss and report it on their own federal income tax returns.14 Under the check-the-box rules, an LLC is treated as a partnership for federal tax purposes (the default rule), or it may elect to be treated as an association and taxed either as a C or S corporation.

The issues of limited liability and tax classification will often narrow the business entity choices for a particular business venture, but other concerns may prove to be equally important.15 The other considerations that may influence or determine the choice of entity are discussed in the following sections.

A. Ease and Cost of Formation

A partnership is simply “an association of two or more people to carry on as co-owners a business for profit.”16 As such, there is usually no legal requirement that a general partnership have any written documents governing its formation or operation. Unlike a general partnership, limited partnerships are recognized as a business entity only because state legislatures have authorized their creation. Thus, limited partnerships are required to execute a certificate of limited partnership and file it in the state where it is formed and in states where it will conduct business. Similarly, an LLC is a creature of state law and must file articles of organization, much as a corporation files articles of incorporation. In addition, every partnership and LLC should have a detailed partnership or operating agreement.17

Partnerships, both general and limited, and especially LLCs allow for more flexibility in operation, management structure, tax allocations, and determining the

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14 In rare situations, an S corporation may face a tax on its earnings, such as when its passive income exceeds 25% of its gross receipts. Id. ¶ 3.11.
15 A new business that anticipates needing an influx of capital from new investors and is planning an IPO will usually opt to be a C corporation from the start (although it is also possible to form an LLC and then convert to a C corporation). Similarly, parents running a family business, who wish to keep management of the business in their hands, will often form a limited partnership naming themselves as general partners and the children as limited partners.
17 Although most jurisdictions do not require a partnership or an LLC to have business agreements (partnership or operating agreements), it is inconceivable to this author that any informed entrepreneurs would consider a business venture as a partnership or LLC without a comprehensive, professionally drafted agreement.
relationship between the entity and the partners or members and the relationship among the partners and members than is available in either a C or S corporation.\textsuperscript{18}

Because state law allows partners and LLC members such wide latitude in forming the contract that governs the entity’s operations, it is generally more expensive to set up a partnership or LLC and draft the partnership operating agreement than it is to form a corporation. Corporations have much less flexibility in their operations than partnerships and LLCs, and frequently practitioners are able to use boilerplate language for much of the corporate governance documents.

B. Ease of Operation

Corporations must adhere to strict formalities as provided by law, such as holding annual meetings. Partnerships and LLCs can operate informally and determine for themselves how to handle issues such as the consensus required to make a decision, like admitting a new partner or member or choosing to dissolve the entity.\textsuperscript{19} Because an LLC is allowed to operate in such an informal manner, more and more closely held businesses that would have otherwise elected to be corporations (to obtain the benefit of C or S corporation federal taxation) have opted instead to do business as an LLC, and then elect C or S tax treatment under check-the-box.

Using an LLC, owners of rental real estate, real estate developers, or property managers can conduct business activities without the complexities required when using a corporation or limited partnership. Large-scale, commercial-property developments often involve sophisticated entrepreneurs who have joined together for the singular purpose of that project. An LLC allows them the greatest freedom to negotiate the terms of their deal within the context of the LLC operating agreement, while at the same time insulating themselves from personal liability in the event the project takes an unfavorable turn.

Similarly, holders of rental real estate or small businesses that manage real estate prefer LLCs so that they can segregate their properties or activities as much as possible for liability purposes. Moreover, they need not deal with the complexities involved when conducting business as a corporation.

\textsuperscript{18} For example, corporate profits are distributed to shareholders based upon stock ownership; partnerships and LLCs have some flexibility in allocating profits and losses to partners or members.

\textsuperscript{19} Most practitioners discourage LLC members from adding formalities, such as annual meetings, to their operating agreement because, if the formalities are added, they must be adhered to.
C. Securities Concerns

Federal securities laws are extremely complex. Registering and complying with SEC requirements is expensive and time consuming. Registration requires extensive disclosure, subjecting owners to significant public exposure. SEC regulation continues throughout the life of an entity that is required to register and, thus, compliance costs are ongoing.

SEC v. W.J. Howey Co. has become the benchmark for determining whether an arrangement is an investment contract, hence a security requiring registration. In determining whether a venture constitutes an investment contract and thus subject to the registration requirements of the Securities Act, courts usually look to three factors (the W.J. Howey test): (1) there must be an investment of money in a common enterprise, (2) with the expectation of profit, (3) solely from the efforts of others.

General partnership interests ordinarily are not considered investment contracts because there normally is no expectation of profits to be derived solely from the efforts of others. A limited partnership interest is generally classified as an investment contract.

Every state has its own set of securities statutes, known as Blue Sky laws. These laws are not preempted by the federal securities laws. Instead, the two regulatory schemes operate side by side. A discussion of state securities statutes is beyond the scope of this article. Although each state’s definition of a security may vary, the vast majority of the state statutes use a very similar definition of a security as found in the federal securities acts. See Unif. Sec. Act § 401(1); Securities Act of 1933 § 2(1); Securities Exchange Act of 1934 § 3(a)(10).

The Securities Act defines a security as any note, stock, treasury stock, security futures, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights... or in general, any interest or instrument commonly known as a “security”, or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing.


See, e.g., Williamson v. Tucker, 645 F.2d 404 (5th Cir. 1981). The Williamson court stated that a general partner had a very high burden in establishing that a general partnership interest was a security. However, the court gave three examples in which a general partnership interest or joint venture interest could be held to be a security:

1. The agreement among the parties leave so little power in the hands of the investor that “the arrangement in fact distributes power as would a limited partnership”;
2. The investor is “so inexperienced and unknowledgeable in business affairs that he is incapable of intelligently exercising his partnership or venture powers;” or
3. The investor is “so dependent on some unique entrepreneurial or managerial ability of the promoter or manager that he cannot replace the manager or otherwise exercise meaningful partnership power.”

Id. at 422.
investment contract and, therefore, a security.\textsuperscript{24} The reason is that such interests involve the limited partners investing money in the partnership with the expectation that profits will result from the efforts of the general partners.\textsuperscript{25}

Whether an LLC membership interest is a security will be decided much like general and limited partnership cases. Does the member expect profits to come solely from the efforts of others? Where a member is also a manager of the LLC, it is clear that there is no expectation that profits would be derived solely from the efforts of others. The issue may be less clear in situations in which the LLC is member-managed, but some of the members are not actively involved in management of the enterprise.\textsuperscript{26}

Unless a real estate development project needs outside investors, who will not be actively involved in the project or in decision-making, an LLC is the ideal choice of entity for real estate entrepreneurs who will be actively involved in the LLC’s operations because state statutes provide flexibility for the entrepreneurs to decide how to operate the LLC.\textsuperscript{27}

\textbf{D. Single Ownership}

If the LLC is owned by only one person or another entity, the entity is ignored for federal tax purposes, unless the single-member LLC elects to be an association taxed as a corporation. Thus, under the check-the-box default classification, if an individual owns an LLC, that individual will be treated as a sole proprietor for federal tax purposes.\textsuperscript{28} If a corporation or other entity owns the LLC, the LLC will be treated as a division of the corporation or entity, and the LLC’s earnings will flow through to the single-member owner. By definition, a partnership cannot consist of a single member.

In a single-member LLC, the fact that the member is treated as a sole proprietor, may increase the possibility of exposure of the member’s other assets to claims of creditors of the LLC on the theory that the LLC’s separate existence should be ignored for purposes of ascertaining the sole member’s personal liability.

\textsuperscript{24} See, e.g., \textit{Goodman v. Epstein}, 582 F.2d 388 (7th Cir. 1978).
\textsuperscript{25} See, e.g., \textit{Mayer v. Oil Field Sys. Corp.}, 721 F.2d 59 (9th Cir. 1983).
\textsuperscript{26} If the LLC operating agreement provides that LLC members retain real power, and does not delegate all the authority to a manager or managing members, it is unlikely a court would hold that the membership interests were securities, particularly if there are a limited number of members. If almost all of the power is delegated to managers or managing members, and there are a large number of members, the investment looks more like a limited partnership and a court would be more inclined to treat the membership interests as securities.
\textsuperscript{27} Even if the real estate project needs investors who will not be actively involved and will rely on the LLC managers’ expertise for their profits, an LLC still provides more flexibility in operation than a corporation under state laws and can elect C or S corporation tax treatment under the check-the-box rules. There are still some investors more familiar with corporations and shares of stock. They may be reluctant to invest in an LLC. However, an LLC that economically functions like a corporation and is subject to corporate tax laws may alleviate investor concerns and still allow the LLC managers to have a great deal of flexibility in the day-to-day operations and management of the LLC.
\textsuperscript{28} In a community property state, a husband and wife can choose to be treated as a single individual for purposes of operating an LLC as a disregarded entity. Rev. Proc. 2002-69, 2002-45 I.R.B. 831.
The member, in other words, could be treated for liability purposes as if he were a general partner, with unlimited exposure to liability for claims against the LLC.

A bankruptcy case\textsuperscript{29} demonstrates other risks associated with the single-member LLC. In that case, the sole member’s LLC filed for bankruptcy. The bankruptcy trustee took the position that because there were no other members to object or consent, the trustee succeeded to all the rights and privileges of the sole member under the governing state statute, including the right to manage the entity. The court agreed and directed that the trustee would be treated as the assignee of all the member’s rights in the LLC, including the right to manage the LLC and to liquidate it, distributing the assets to the bankruptcy estate.

\textbf{E. Fiduciary Duties}

The issue of fiduciary duties (the duties of care and loyalty) among the owners and between the owners and the entity is often overlooked or diminished in determining which entity is best suited for a business venture. An LLC provide greater flexibility in negotiating and defining fiduciary duties than any other entity. Corporate officers and directors owe the highest fiduciary duties to the corporation and its shareholders.\textsuperscript{30} This is true because shareholders are not in a position to

\textsuperscript{29}In re Albright, 291 B.R. 538 (Bankr. D. Colo. 2003).

\textsuperscript{30}Section 8.30 of the Model Business Corporation Act provides:

(a) A director shall discharge his duties as a director, including his duties as a member of a committee:

(1) in good faith;

(2) with the care an ordinarily prudent person in a like position would exercise under similar circumstances; and

(3) in a manner he reasonably believes to be in the best interests of the corporation.

(b) In discharging his duties, a director is entitled to rely on information, opinions, reports, or statements, including financial statements and other financial data, if prepared or presented by:

(1) one or more officers or employees of the corporation whom the director reasonably believes to be reliable and competent in the matters presented;

(2) legal counsel, public accountants, or other persons as to matters the director reasonably believes are within the person’s professional or expert competence; or

(3) a committee of the board of directors of which he is not a member if the director reasonably believes the committee merits confidence.

(c) A director is not acting in good faith if he has knowledge concerning the matter in question that makes reliance otherwise permitted by subsection (b) unwarranted.

(d) A director is not liable for any action taken as a director, or any failure to take any action, if he performed the duties of his office in compliance with this section.
Rev. Model Bus. Corp. Act § 8.30 (2002). This statutory provision has been enacted in a majority of states. As noted in the Official Comment, the focus should be “on the manner in which the director performs his [or her] duties, not the correctness of his [or her] decisions.” Id. § 8.30 cmt.

As formulated by the American Law Institute, the business judgment rule establishes that the duty of care has been met if a director (1) does not have a conflict of interest with respect to the subject at hand; (2) “is informed with respect to the subject . . . to the extent the director . . . reasonably believes to be appropriate;” and (3) “rationally believes” that the decision is in the best interests of the corporation. ALI, Principles of Corporate Governance: Analysis and Recommendations § 4.01 (C), (D) (1994).

The second fiduciary duty imposed on corporate directors is a duty of loyalty, also known as a duty of fair dealing. As a fiduciary, a director is obliged to consider the corporation’s interests above his or her own personal interest. Generally, this duty of loyalty extends to transactions between the corporation and the directors, to a director seizing corporate opportunities that would otherwise be available to the corporation, and to competing with the corporation.

The Delaware Supreme Court has stated:

Corporate officers and directors are not permitted to use their position of trust and confidence to further their private interests. While technically not trustees, they stand in a fiduciary relation to the corporation and its stockholders. A public policy, existing through the years, and derived from a profound knowledge of human characteristics and motives, has established a rule that demands of a corporate officer or director, peremptorily and inexorably, the most scrupulous observance of his duty, not only affirmatively to protect the interests of the corporation committed to his charge, but also to refrain from doing anything that would work injury to the corporation, or to deprive it of profit or advantage which his skill and ability might properly bring to it, or to enable it to make in the reasonable and lawful exercise of its powers. The rule that requires an undivided and unselfish loyalty to the corporation demands that there shall be no conflict between duty and self-interest. The occasions for the determination of honesty, good faith and loyal conduct are many and varied, and no hard and fast rule can be formulated. The standard of loyalty is measured by no fixed scale.


Sections 8.60 to 8.63 of the Model Business Corporation Act provide that a transaction between a corporation and a director is voidable unless the transaction is fair to the corporation or disclosure of the transaction is made to disinterested directors or disinterested shareholders who then authorize or ratify the transaction.

The corporate opportunity doctrine is a judicial rule which prohibits a director from taking a business opportunity away from the corporation. Under this doctrine, a director may take advantage of an opportunity if full disclosure is made and the corporation rejects the opportunity. A “corporate opportunity” has been defined as one that is within the line of the corporation’s business. The American Law Institute has defined a corporate opportunity as:

(1) Any opportunity to engage in a business activity of which a director or senior executive becomes aware, either:

(A) In connection with the performance of functions as a director or senior executive, or under circumstances that should reasonably lead the director or senior executive to believe that the person offering the opportunity expects it to be offered to the corporation; or

(B) Through the use of corporate information or property, if the resulting opportunity is one that the director or senior executive should reasonably be expected to believe would be of interest to the corporation; or
bargain or enter a contract governing how the corporation will operate. An LLC operating agreement is a contract between the members that determines how the entity will function and how the rights and responsibilities of the members and managers to each other and to the LLC are defined.\(^{31}\)

In 2004, Delaware first allowed LLCs to limit and define fiduciary duties for members, managers, and other persons who might normally have fiduciary and other duties to each other and to the LLC. Delaware’s statute provides that a member’s or manager’s or other person’s duties may be expanded, restricted, or eliminated by the LLC agreement.\(^{32}\) However, the LLC agreement may not eliminate the implied contractual covenant of good faith and fair dealing.\(^{33}\) Many states have now amended the statutory LLC fiduciary duty provisions to provide LLC members with flexibility in eliminating or defining fiduciary duties.\(^ {34}\) Most state statutes allow fiduciary duties to be restricted, redefined, or substantially eliminated, provided that the standards are “not unreasonable.”\(^ {35}\)

The ability to restrict, define, or eliminate fiduciary duties is an advantage in using LLCs in real estate ventures involving established and experienced entrepreneurs. It is not uncommon for a real estate project to include financiers, architects, developers,

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(2) Any opportunity to engage in a business activity of which a director or senior executive becomes aware and knows is closely related to a business in which the corporation is engaged or expects to engage.

**ALI, Principles of Corporate Governance: Analysis and Recommendations** § 5.05(B) (1994). The final type of conduct that is related to a director’s duty of loyalty is closely related to the corporate opportunity doctrine. Directors are generally prohibited from competing with the corporation.\(^ {31}\) Delaware has a history of allowing business organizations great flexibility to contract between the members or partners for the agreement that they want. The underlying notion seems to be that astute businesspeople can decide for themselves how they want their business entity to be run. Perhaps, if there is any cause for alarm it is in regards to the unwary investor who is putting money into an LLC, which has an agreement that has eliminated fiduciary duties.

Professor Daniel Kleinberger, William Mitchell College of Law, summed it up this way:

First, no one should make the mistake of thinking the “eliminate” [fiduciary duties] [LLC] legislation is “conservative” in any meaningful sense of that word. Of course, “conservative” means many different things, and has many different aspects, but at the core of conservative thought is a distrust of human capacity to predict accurately the consequences of radical change. As a result, the law of unintended consequences is part of the conservative’s worldview, and a conservative is accordingly cautious about change. As the Delaware Supreme Court has recently written “scrupulous adherence to fiduciary duties is normally expected.” Therefore, to empower private parties to eliminate fiduciary duties is radical. It is of the essence of fiduciary duties that—for various reasons—even those who think they know better should lack the power to convert their relationship of dependence to the pure arena of the “morals of the marketplace.”


\(^{32}\) Del. Code tit. 6, § 18-1101(c) (2009).

\(^{33}\) The implied covenant of good faith and fair dealing is an obligation that is contractual in nature; thus, in effect, Delaware has allowed LLC agreements to eliminate all fiduciary duties.


\(^{35}\) *Id.*
contractors, and others who come together for a particular project, with the goal of sharing in the profits. These entrepreneurs are often involved in other ventures and wish to continue pursuing other real estate opportunities. The inflexibility of corporate fiduciary duties would, at a minimum, make it cumbersome for entrepreneurs to share in the real estate venture and also pursue other real estate opportunities without first presenting and offering the opportunity to the corporation.

F. Charging Orders

A charging order can be granted to the creditor of an LLC member or of a partner. It serves to assure the creditor of receiving distributions made by the LLC, while restricting the right to participate in management to those admitted as members. It also reinforces the statutory rule of law that the assets of an LLC are not the assets of the individual LLC members. Charging order provisions make LLCs and partnerships particularly attractive to closely held businesses and real estate ventures in which the owners want no outside interference with the business operations.

With a corporation, a stockholder’s creditor is able to receive a judgment and upon receiving the debtor’s stock is able to exercise all of the rights of the debtor stockholder, including management (voting) rights as well as the rights to distributions. Thus, the other stockholders may face a situation in which the creditor/stockholder’s interests are divergent from their own. The creditor may be more inclined to seek rapid distributions from the corporation instead of having any concern for on-going corporate projects.

An LLC’s charging order protections ensure that even if a member of the LLC has past debts or incurs future debts that result in a judgment for a creditor, the creditor will only be entitled to normal financial distributions that would otherwise go to the debtor/member. The debtor/member retains all of the rights of management that the member previously had and the LLC is not confronted with a new and unexpected member. Where LLC members are individually essential to the success of the LLC business, such as in a real estate development venture, charging orders provide the LLC and its members with some security that a member’s outside economic problems will not result in the member being unable to perform the duties and obligations that the member agreed to provide to the LLC’s business ventures.

G. LLCs and S Corporations

LLCs can be used in a wider range of circumstances than can S corporations. For example, S corporations may have no more than 100 shareholders. With limited exceptions for certain trusts, shareholders in S corporations must be individuals. Other types of investors, such as corporations and partnerships, are not eligible to become S corporation shareholders. In addition, S corporations may only issue a single class of stock. LLCs are not subject to any of these restrictions.

LLC members may allocate income or loss on a basis other than allocation according to each member’s percentage interest in the LLC. By contrast, in an S corporation all allocations must be based strictly on the stock ownership interest of each shareholder.

There are some advantages that can be achieved by being taxed under subchapter S that cannot be achieved if an entity is classified as a partnership for federal tax purposes. As a partnership, the partners will be subject to self-employment tax on their net earnings from self-employment. An S corporation may pay shareholders who perform services to the entity reasonable compensation (wages) for those services. These wages are not subject to self-employment tax. An S corporation may also establish an employee stock ownership plan (ESOP). An ESOP maintained by an S corporation is permitted to provide for distributions only in cash or for distributions of employer securities subject to a repurchase requirement that meets the requirements of I.R.C. 409(h)(1)(B). These same rules apply to an LLC that elects to be taxed as an S corporation, provided the LLC meet all the requirements for subchapter S taxation (e.g., single-class of stock, etc.).

H. LLCs and Limited Partnerships

As mentioned previously, the formation of a limited partnership requires having a general partner who has unlimited liability for the debts and obligations of the limited partnership. In addition, in most states, a limited partner may not materially participate in the activities of the limited partnership. Even if a state allows a limited partner to be actively involved in the operations of the limited partnership, the issue of whether a limited partner is able to avoid the passive activity loss rules under IRC § 469 is of concern, especially for an investor / limited partner who does not want to be in a position where losses incurred in the passive activity can only be deducted from income derived from other passive activities. In most cases, an investor would like the flexibility to offset losses from passive activities against income from on active and portfolio income.

Two recent federal court decisions have provided LLC members with much greater opportunities to deduct “passive” losses against active income. In both of these cases, the court held that an LLC member is a general partner for purposes of the passive activity loss rules. Thus, unlike a limited partner, an LLC member will be treated as a general partner for purposes of the passive activity loss rules (even if the member is not actively involved in the LLC’s operations) and can use the amount of

37 I.R.C. §§ 1401, 1402(a) (2009) (stating that a general partner must pay self-employment tax on the partner’s distributive share of the net income from any trade or business carried on by the partnership).
38 I.R.C. §§ 409(h)(2)((B) (2009). By forming an ESOP, an S corporation and its shareholders can avoid liability for tax on the income that flows through to the ESOP and enjoy other benefits under the plan. A partnership may not form an ESOP for its employees.
39 An LLC may elect to be taxed as a corporation under the check-the-box rules and then file IRS Form 2553 and elect S corporation taxation.
the LLC’s losses, which pass through to the member, to reduce income from passive, active and portfolio income.

I. LLCs and REITS

A Real Estate Investment Trust (REIT) is a corporation (or a trust or association taxed as a corporation), that invests in real estate, mortgages, and similar assets. The effect of a REIT election is that the REIT is taxed at corporate rates on undistributed income and capital gains. Income that the REIT distributes to its shareholders is taxed only to the shareholders, not at the REIT level. Although income and capital gains pass through to the owners, losses and credits do not.

REITs are subject to intricate rules, including unique federal tax rules. A REIT holds passive investments in real property equity and mortgages. REIT shares can be publicly traded, providing access to the public markets as a source of capital and solving the liquidity problem that LLCs and partnerships sometimes experience. REITs are also subject to limitations on the manner in which rental arrangements are structured, on the types of services that may be provided to tenants, and the extent to which they may directly provide services. REITs generally may not engage in real estate dealer-type activities, such as the construction of property to be held for sale. REITs are formed under state statutes that provide that REIT shareholders are not liable for the debts of the business. LLC members, unlike general partners, enjoy this same liability protection.

If real estate is held by several owners, REITS are good vehicles for owners to sell their interest in the properties. It is more difficult to sell a partnership or LLC membership interest, but the limitations placed on a REIT’s operation makes it unsuitable for many real estate ventures.

J. Summary—LLCs Are the Entity of Choice in Real Estate

LLCs provide property owners who lease their properties the opportunity to place each property into a separate LLC and avail themselves of personal liability protection from the debts and obligations of the properties. They may also segregate the debts and liabilities of each property from those of the other properties. LLCs also allow real estate entrepreneurs, pursuing more complex ventures, nearly unlimited options to decide for themselves how the entity should operate and how profits and losses should be distributed, while also limiting the participants’ liability for the debts and obligations of the LLC.

LLCs are the entity choice for many types of business endeavors, both simple and sophisticated. LLCs are well suited as an entity for experienced and astute businesspeople who are not relying on the expertise of others to make a profit. LLCs are an ideal entity whether entrepreneurs are joining together for a single project, a series of projects, or an on-going business.

Real estate ventures frequently utilize the talents of many individuals, who bring different skills to the project. As with any risky enterprise, these participants are
aware of the risks involved in real estate (especially in today’s economy) and they expect substantial economic rewards for their investment, and the time and energy they expend on successful projects. LLCs, more than any other type of entity, allow these savvy businesspeople the most freedom to bargain with each other for a deal that best suits them and then to make their own contract—the LLC operating agreement.

LLCs have become such a widely used entity for holding individual properties or for segregating various aspects of real estate development and management projects, it would seem that the opportunity to accomplish these same goals, within the framework of a single LLC, would result in a surge of series LLC filings for real estate businesses in the states that permit series LLCs. This has not been the case.

IV. SERIES LLCs

A series LLC is a “form of entity with internal funds, portfolios, cells, or divisions, each of which may have separate members, managers, assets and liabilities, and business purpose or investment objectives.”

“Series” is also the term that describes “each of the separate components.”

A. Delaware Series Statutes

In 1996, Delaware became the first state to permit the creation of separate series within an LLC. The debts and other liabilities of each series are only enforceable against that series. Each series is recognized as a distinct entity for state law purposes, and each series can have its own separate business purpose. A series can also be terminated without affecting the other series of the LLC.

Even though a Delaware series LLC has been available to businesses since 1996, few have opted to use Delaware series LLCs. Practitioners recognized the potentially huge benefits to some types of businesses in forming series LLCs, but only if more states adopted series LLC legislation and there were fewer unknowns.

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41 Allan G. Donn, et al., SERIES LLCs, in ALI-ABA TOPICAL COURSES: CHOICE OF ENTITY (2009).
42 Id. See also Sandra Mertens, Series Limited Liability Companies: A Possible Solution to Multiple LLCs, 84 CHI.-KENT L. REV. 271 (2009) (advantages and disadvantages to the use of series LLCs to avoid the expense and complication of forming multiple LLCs).
43 Delaware statutes also allow series limited partnerships, see Del. Code tit. 6, § 17-218(b) (2009), and series statutory trusts, see Del. Code tit. 12, § 3804(a) (2009).
45 Until recently, practitioners referred to “series LLCs” as “Delaware series LLCs” because Delaware was the only state to provide for creating a series within an LLC.
46 In 2007, approximately 100,000 LLCs were formed in Delaware; about 1000 of those were series LLCs. In 2008, approximately 87,000 LLCs were formed in Delaware and, again, about 1000 were series LLCs. There are now a total of 3500 series LLCs in Delaware with over half of those formed within the past two years. Allan G. Donn, ALI-ABA Webcast, Choice of Business Entity—2009 Update: Choosing and Using Business Forms in Uncertain Times (Feb. 17, 2009).
Series were first used by mutual funds, which created series trusts. Typically, the mutual fund created one trust, and a different series of the trust would be created for each asset class within the fund. As far back as 1949, the Tax Court held that several series of a single investment trust may be treated as distinct taxable entities. In the case of a regulated investment company having more than one fund, each fund is generally treated as a separate corporation for federal income tax purposes. Mutual funds used series trusts so that they could form one legal entity, with a single board of directors and file a single registration under the Investment Company Act of 1940. Usually, series funds are formed as either corporations or business trusts, such as a Delaware statutory trust.

Under the Delaware series statutes,

1. the LLC agreement establishes a series and specifies the rights, powers and duties with respect to property of the LLC;
2. separate and distinct records must be maintained for each series;
3. the assets associated with any series must be held in separate and distinct records and accounted for in such separate and distinct records separately from other assets of the LLC or any other series (and the company agreement must specifically require that these steps be taken); and
4. notice of the limitation on liability of the series must be set forth in the LLC’s certificate of formation.

In 2007, Delaware amended its series LLC statutes to provide that each series had the power to contract, hold title to assets, grant liens and security interests, and sue and be sued, in its own name. In 2007, Delaware amended its series LLC statutes to provide that each series had the power to contract, hold title to assets, grant liens and security interests, and sue and be sued, in its own name. However, whether a series within an LLC is a separate entity is not made clear in the Delaware statutes. This creates a number of problems in the context of real estate properties and ventures.

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Bar Association’s annual limited liability entities seminar panelists “expressed serious reservations about the use of series LLCs;” panelists expressed concerns that courts would not understand series LLCs, bankruptcy laws do not acknowledge series LLCs, securitized lenders do not recognize series LLCs as single-purpose entities, the IRS has not determined whether each series is a separate tax partnership, and state taxation of series in states without series statutes was unknown; see also Dem A. Hopkins, Annual ALI-ABA Satellite Conference Looks at New Developments in Limited Liability Entities, CCH’s LLC ADVISOR, April 2008, at 4 (stating that as in past years, The American Law Institute-American Bar Association’s annual limited liability entities seminar panelists “generally feel that not enough is known about how the IRS and state courts will decide legal and tax issues related to series LLCs” to encourage clients to use a series LLC).

49 I.R.C. § 851(g) (1997).
50 THOMAS A. HUMPHREYS, LIMITED LIABILITY COMPANIES § 1.04 (2006).
53 Id. § 18-215(c).
B. Illinois Series Statutes

The Illinois series LLC statutes were the first state series statutes to include specific provisions stating that each series is a separate entity in all respects. Each series may contract with any party, hold title to property, grant security interests, and sue or be sued in its own name. The Illinois statutes also allow the various series to elect to contract jointly, work cooperatively, be treated as a single business for purposes of qualifying to transact business in other states and otherwise consolidate their operations to the extent permitted by law.

Because Illinois specifically provides that each series is a separate entity (unlike Delaware and most states with series statutes), the liability shield between the various series within the LLC should be much stronger than in other jurisdictions. However, it is impossible to know with certainty until a body of law is developed through litigation and court decisions. An important advantage that the Illinois series statutes provide to real estate ventures and holdings is that each series can receive a certificate of good standing, unlike a separate series in Delaware.

C. Summary of Other Series Statutes

Currently, Delaware, Illinois, and six other states have enacted series LLC statutes. In addition, three states have enacted LLC statutes that provide for “series” ownership, but have not enacted full series legislation modeled after either Delaware or Illinois. These three states allow series ownership interests but do not provide a liability shield between the different interests. As a result, they are not well-suited for multiple real estate ventures or holdings within a single LLC. Puerto Rico also provides for the formation of series LLCs.

D. Series Operating Agreements

States that have enacted series LLC legislation provide that an LLC’s operating agreement is the appropriate document to establish or provide for series within the LLC. In addition, it may be crucial that the LLC operating agreement

55 805 ILCS 180/137-40(b) (2009). Iowa has since followed this lead. See Iowa Code § 490A.305.
56 805 ILCS 180/137-40(b) (2009).
57 Id.
58 See Symonds & O’Toole, supra note 54.
62 See, e.g., 805 ILCS 180/37-40(a) (stating that [a]n operating agreement may establish or provide for the establishment of designated series of members, managers or limited liability interests having separate rights, powers or duties with respect to specified property or obligations of the limited
provides for series within the LLC, if the LLC expects to receive the full protection to which each series is entitled under state law.63

Although state statutes do not require that each series within the LLC have its own operating agreement, the same concerns that dictate that an LLC have a written operating agreement also apply to each series within the LLC. It may seem tempting to simply include the standard operating agreement provisions for each of the LLC’s series within the overall LLC operating agreement. However, this author advocates creating separate operating agreements for each of the series within the LLC.

First, creating separate operating agreements for each series reinforces their separateness. Second, the initial cost benefit of including the operating agreement of each series in the overall LLC agreement is likely to be negligible. Third, LLC members may not be members of each of the series within the LLC. Allowing the members of each series to determine how that series will operate, without the threat that LLC members with no involvement in that series can amend the overall operating agreement and impact the series, is something most seasoned business people would demand. For example, in a real estate venture, real estate developers and contractors may hold a greater interest in the series formed to develop the project while the property manager(s) may hold a greater interest in the series that is responsible for managing the property. However, these members also may hold smaller interests in series that are not related to their areas of expertise. Providing for each series to have its own separate operating agreement allows these business

liability company or profits and losses associated with specified property or obligations, and to the extent provided in the operating agreement, any such series may have a separate business purpose or investment objective).

63 For an example, see, Iowa Code § 490A.305, which provides:

1. An operating agreement may establish or provide for the establishment of designated series of members, managers, or membership 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, to the extent provided in the operating agreement, any such series may have a separate business purpose or investment objective.

2. Notwithstanding contrary provisions of this chapter, the debts, liabilities, and obligations incurred, contracted for, or otherwise existing with respect to a particular series shall be enforceable against the assets of that series only, and not against the assets of the limited liability company generally, if all of the following apply:
   a. The operating agreement creates one or more series.
   b. Separate and distinct records are maintained for that series and separate and distinct records account for the assets associated with that series. The assets associated with a series must be accounted for separately from the other assets of the limited liability company, including another series.
   c. The operating agreement provides for such limitation on liabilities.
   d. Notice of the limitation on liabilities of a series is set forth in the articles of organization of the limited liability company. Filing of articles of organization containing a notice of the limitation on liabilities of a series in the office of the secretary of state constitutes notice of the limitation on liabilities of such series.
professionals to operate their series within the overall LLC framework with the
degree of autonomy that they are accustomed to having.  

Finally, creating a separate operating agreement for each series may be
extremely cost efficient in the event that a series within the LLC is involved in
judicial proceedings. The ability to provide the court with an operating agreement for
the individual series, instead of a much larger and more complex LLC operating
agreement governing the LLC and all of its series, should result in some measure of
judicial economy and reduce the risk of judicial confusion.

E. Separateness of Each Series

Delaware provides that each series is treated “in many important respects” as if
the series were a separate LLC.  Under Delaware’s series LLC statutes, a series may:

1. establish designated series of members, managers or LLC
   interests or, of assets having separate rights, powers and duties,
   and each series may have a separate business purpose;
2. have the debts against one series enforceable against only the
   assets of that series and not against the assets of any other
   series within the LLC;
3. apply the statutory limitation rules on distributions separately
   to each series;
4. allow a member to dissociate from one series and still maintain
   membership in other series and the LLC; and
5. terminate and wind up the affairs of a single series without
   causing the LLC to terminate (also a judicial termination can
   involve a single series instead of the LLC itself).

Illinois expands on Delaware’s enumerated series provisions in many ways.
Illinois specifically allows each series to elect to be treated as a separate entity,
effectively operating as a separate LLC.

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64 Some LLC members who are members of some, but not all, of the series involved in a real estate venture
may have some concerns that actions by one series will affect the other series. The LLC operating
agreement could include some guidelines that each series operating agreement must follow. For example,
a provision that each series operating agreement contain a clause that none of the assets of any series may
be sold without the approval of all of the LLC members. However, the LLC members should show
restraint in providing mandates for the series within the LLC operating agreement. In the event there are
problems within a series that lead to a court’s having to construe the series operating agreement, it should
not be necessary to refer to the LLC operating agreement in order to determine the meaning of the series
operating agreement or its intent.
65 After all these years, some courts still refer to LLCs as “limited liability corporations.” Just as courts
have struggled with the concept of LLCs, they will struggle with the idea of separate, autonomous series
within an LLC. Focusing a court’s attention on the operating agreement of the individual series instead of
the LLC and all of the series within it, increases the likelihood that the provisions of the series operating
agreement will be respected.
68 805 ILCS 180/37-40(b); see also supra text accompanying notes 55-57.
At least one court has questioned whether a series has the capacity to sue and be sued in its own right.\(^6^9\) In that case, title to a boat was placed in a series, but its operations were managed by the LLC. It was argued that a Delaware LLC and its series are distinct entities, like a corporation and its subsidiary, and the LLC may not pursue legal claims in relation to assets placed in a series. The court concluded, however, that the unique relationship between a Delaware LLC and its series does not create a truly separate legal entity capable of independently pursuing its own legal claims. The transfer of title in the vessel to the series was “nominal,” meaning that the transfer did not result in a transaction that deprived the LLC of the contract and tort rights that arose from its relationship with third parties, so that the LLC remained the “real party in interest” with respect to claims against those third parties.

Generally, establishing an LLC’s separateness for purposes of limited liability protection requires the members to treat the LLC as a distinct and separate entity. An LLC must adhere to rules similar to those imposed on corporations\(^7^0\) to prevent its veil from being pierced and its members from being personally liable for the debts and obligations of the LLC. Key among the requirements of separateness is that the members do not treat the LLC as a mere extension of themselves. Commingling personal funds with LLC funds, using LLC funds to pay personal expenses, and failing to maintain adequate records are key issues that could result in a court piercing an LLC’s veil and holding the members personally liable to creditors.

Although courts have not addressed the issue of whether these same standards apply to piercing the veil of a single series, it is likely that the same rules will apply to each series. Tax and legal practitioners are now familiar with the necessity of advising clients that the LLC must be treated as a separate legal entity. Even so, courts continue to allow creditors to pierce the LLC veil, because the members did not follow this advice.

Will a series LLC or a series within the LLC be vulnerable to having its veil pierced? Practitioners should evaluate both their clients’ level of sophistication and whether they have the resources to hire professionals that will ensure financial separateness. An LLC that contains numerous series will still require that books and records be maintained for each series as if it were a separate LLC. It will be tempting for a series LLC to ignore the need for separateness, such as paying employees who provide services for more than one series from the funds of a single series or using assets of one series that currently has available funds to pay the debts of another series. These types of practices could have a domino effect, resulting in a court piercing the veil of each series (and even the LLC, itself).

\(^7^0\) The fundamental factors associated with piercing the corporate veil include undercapitalization, failure to observe corporate formalities, failure to pay dividends, personal use of corporate funds, absence of corporate records, and the use of the entity as the alter ego of the principal shareholders or to promote fraud. See generally 1 William M. Fletcher, Cyclopedia of the Law of Private Corporations § 41.10 (perm. ed. rev. vol. 2005). See also Christopher S. McLoon and Margaret C. Callaghan, The Dangerous Charm of the Series LLC, 24 ME. B.J. 226 (2009) (finding substantial risk of liability if the series structure is not respected for state law purposes).
If a practitioner is confident that the clients’ are experienced entrepreneurs, a series LLC should provide the same veil-piercing protections as a non-series LLC. And, like the creation of separate LLCs, a series LLC allows high-risk ventures, such as real estate projects, to separate the high-risk activities from those with lesser risks. For example, the construction of property carries a higher risk than the management of the property. Similarly, the risks inherent in ownership of commercial or industrial property are probably greater than the risks of ownership of residential property. A series LLC is an efficient way to separate these risks into individual series that are liable only for the activities of that series (e.g., construction, residential property management, commercial property management). This should be particularly attractive to larger investors who, although they are not personally liable for the debts and obligations of the LLC or its series, are liable up to the amount of their contribution (or promised contribution) to the LLC and its series. These investors will be able to invest in the single LLC and then have their investment split among the different series so that it is distributed among high-risk and low-risk activities.

The key to obtaining liability protection within a series LLC may well hinge upon whether a state’s LLC statute explicitly provides that a series LLC is entitled to have each series within the LLC treated as a separate legal entity. This is, perhaps, the most crucial factor in deciding where to form the series LLC.71

With so much focus on keeping the individual series separate from each other, the need to keep the series’ business and operation separate from the LLC’s business is also something that should be an important concern. A judicial finding that the LLC’s business operations are indistinguishable from the business operations of the series may result in a court disregarding the separateness of the LLC and the series. This issue is complicated because the LLC members will be members of the LLC and members of some or all of the series. One solution is to use the LLC as an umbrella business entity, which will pursue real estate opportunities and decide at the LLC level whether to include a new venture within the LLC. Then, the new venture should be placed in its own series. If the LLC is not actively involved in the real estate projects, including holding the property title, the less likely it can be argued that the LLC is the real party in interest.72

F. Registration and Recognition of Series LLCs in Jurisdictions Without Series LLC Statutes

For most states without series LLC statutes, it is unclear whether it is sufficient that a series LLC files a certificate of authority to do business in the state or whether the state courts will respect the separateness of each series within the series

71 However, if the real estate operations are taking place, wholly or in part, in a state that does not recognize series LLCs, the formation of the series LLC in the state with the strongest provisions for the legal separateness of each series may be an exercise in futility. See Symonds & O’Toole, supra note 54.
72 The goal is to avoid a finding similar to one that the LLC is the real party in interest. See supra text accompanying note 69.
LLC. Even if a state without series LLC statutes allows a foreign series LLC to obtain a certificate of authority to transact business within the state, will the shield that presumably protects each series from the liabilities of the other series be respected?

Most state statutes provide that the internal affairs and the internal liability of a foreign LLC’s members and managers are governed by the laws of the state of formation. There is “no assurance that a state without an express provision on the internal liability shield [of an LLC series] will recognize the shield created by the state of organization.” It is unclear whether the ‘general provision of the LLC’ acts of other states recognizing that the law of the state of foreign organization governs the liability of ‘its members and managers’ and has the same result as the specific provisions of the series statutes. Thus, a series LLC, operating in a state that does not have statutory provisions that recognize the internal liability shields provided for under the state of formation’s LLC series statutes, cannot be assured that the LLC or each series within the LLC will receive the same liability protection in the foreign state as it would in the state of its formation.

G. Series Bankruptcy Issues

Because series LLCs are a relatively new form of business organization, a number of bankruptcy issues regarding this kind of entity remain unresolved. It has not been determined conclusively whether a series of a series LLC can qualify to be a debtor under the Bankruptcy Code. Ordinarily, subsidiary corporations are recognized as entities separate and apart from parent or other allied corporations. It is only after an evidentiary demonstration that two entities have the same debts and assets or that their affairs are inextricably intertwined that they can be considered as one and accordingly amenable to consolidation in bankruptcy proceedings. It is possible that a court will treat each series of the LLC as being equivalent to subsidiary corporations, but that issue has not yet been decided definitively.

73 Generally, only states with series LLC statutes explicitly recognize foreign series LLCs (with the exception of Utah and Nevada). See Donn et al., supra note 41. California will recognize the separateness of each series in a foreign series LLC provided “(1) the holders in interests in the series are limited to the assets of the series on redemption, liquidation, or termination, and may share in the income only of that series; and (2) under state law, the payment of the expenses, charges, and liabilities of that series is limited to assets of that series.” Id. (citing California FTB Informational Publication No. 689 (Feb. 1, 2007)).
75 Donn, supra note 41.
76 Carter G. Bishop & Daniel Kleinberger, Limited Liability Companies ¶ 14.06[1], at S14-33 (2006 Cum. Supp. No. 2); see also Butler v. Adoption Media, LLC, 436 F. Supp. 2d 1022, 1072 (N.D. Cal. 2007) (stating that internal affairs and liability of LLC members and managers, under California’s recognition of foreign LLCs, do not apply to disputes between the foreign LLC and entities or creditors that are not part of the LLC).
79 Generally, the separate identity of an LLC will be recognized and respected. See In re Desmond, 316 B.R. 593 (Bankr. D.N.H. 2004).
It is unresolved who has the authority to file a bankruptcy petition on behalf of the series. Presumably the operating agreement for the LLC will authorize the managing member or some defined percentage of the members to file the petition. But that does not necessarily mean that the same provision will apply to a filing on behalf of one or at least fewer than all of the series.

Some, but not all executory contracts are enforceable in bankruptcy. It remains to be seen whether a bankruptcy court would enforce any or all provisions of the operating agreement that govern the series LLC. Transfers of property and other transactions between and among the constituent series, the LLC, and the members could be challenged as fraudulent or preferential in bankruptcy under some circumstances.

H. Federal and State Taxation of Series LLCs

A key issue that practitioners have cited for opting not to use series LLCs is the uncertainty of federal tax treatment. The IRS has recently proposed regulations providing guidance on the federal taxation of series LLCs and the series within an LLC.

Under the proposed regulations, whether or not a series of a domestic series LLC is a juridical person for local law purposes, for federal tax purposes it is treated as an entity formed under local law. As a result of the IRS treating a series as a separate entity, the rules that govern the tax classification of other types of separate entities also govern individual series. Thus, each series of an LLC is subject to the “check-the-box” rules.

Example: A, B and C form a series LLC. A and B own all interests in series 1 and C is the sole member of series 2. Under the proposed regulations and the default tax classification under the check-the-box rules, series 1 would be classified as a partnership for federal

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80 See In re Real Homes, LLC, 352 B.R. 221 (Bankr. D. Idaho 2005).
84 Prop. Treas. Reg. §§ 301.6011–6, 7701–1, 75 Fed. Reg. 55699, 55707 (Sept. 14, 2010). One reason the IRS may have decided to treat each series as a separate entity is that treating a series LLC as a single tax entity could serve to allow taxpayers to avoid paying federal tax that they would otherwise pay. For example, under I.R.C. § 707(a)(2)(B), contributions of appreciated property from one LLC into a new LLC with additional members, in exchange for cash and interests in the new LLC, could be deemed a taxable distribution as an exchange of appreciated property for cash. If the original LLC had instead created a series and then performed the same transaction, and the IRS treated the LLC and the series within the LLC as a single partnership, the distribution of the cash would not be a taxable distribution. Thus, for purposes of raising tax revenue, it may be in the IRS’s best interests to hold each series a separate entity.
85 See supra note 3.
tax purposes and series 2 would be treated as a disregarded entity. However, both series 1 and series 2 could affirmatively elect different tax treatment under the check-the-box rules, such as C corporation or S corporation federal tax status.

With respect to tax collection, the proposed regulations provide that, to the extent federal or local law permits a creditor to collect a liability attributable to a series from the series organization or other series of the series organization, the series organization and other series of the series organization may also be considered the taxpayer from whom the tax assessed against the series may be collected. Moreover, when a creditor is permitted to collect a liability attributable to a series organization from any series of the series organization, a tax liability assessed against the series organization may be collected directly from a series of the series organization.

The proposed regulations require that a series organization and each series of the series organization file an annual statement by March 15th of each year. The IRS is currently considering the type of information the annual statement should require. In addition, the IRS is considering revising Form SS-4, Application for Employer Identification Number, to include questions regarding series organizations.

The proposed regulations do not currently provide how a series should be treated for federal employment tax purposes and do not address any issues arising with respect to the ability of a series to maintain an employee benefit plan. The IRS, however, intends to issue regulations under I.R.C. § 414(o) that would prevent the avoidance of any employee benefit plan requirement through the use of the separate entity status of a series.

Before issuing the proposed regulations, the IRS, in a private letter ruling, provided an indication of where it was headed when it decided that each series within an LLC may be treated as a separate entity for federal tax purposes. The various series discussed in the PLR included single-owner series that were disregarded, multi-owner series, some of which would be taxed as partnerships, and others that would elect to be taxed as corporations. The IRS allowed these different series to have different federal tax classifications.

Most states tax LLCs according to their federal tax classification. The issue of state taxation becomes particularly important if a series is doing business in a state that does not have series statutes. How will series LLCs doing business in these states be taxed? Massachusetts has decided to treat a Delaware series LLC as a separate taxable entity. Most states remain silent on this issue although generally these states treat out-of-state series LLCs as one entity.

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87 See supra note 11 and accompanying text.
89 See Charles R. Levun, The Delaware Series LLC: Sometimes a No-Lose Alternative, CCH’S PARTNERSHIP TAX PLANNING & PRACTICE NO. 198, Apr. 26, 2004. However, California has ruled that each series in a Delaware Series LLC is considered a separate LLC and must file its own Form 568 and pay its own tax. See Ask the Advocate, March/April 2006 Tax News, California Franchise Tax Board, March 22, 2006.
Only the Illinois and Iowa series LLC provisions make it clear that each series is, or may elect to be, treated as a separate business entity. Some commentators have said that the separate business entity language in Illinois’ series statutes was intended to influence the IRS to classify series LLCs as separate business entities for federal tax purposes. In fact, the IRS, in the proposed regulations pointed out that while series are not generally treated as entities for state law purposes, Illinois and Iowa have statutes that allow a series to be treated as a separate entity to the extent set forth in the LLC operating agreement.


Many practitioners were surprised that the Revised Uniform Limited Liability Company Act (RULLCA) did not contain series provisions.

The Drafting Committee considered a series proposal at its February 2006 meeting, but, after serious discussion, no one was willing to urge adoption of the proposal, even for the limited purposes of further discussion. Given the availability of well-established alternate structures (e.g., 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.

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90 See supra note 55 and accompanying text.  
92 RULLCA (2006). The Prefatory Note to the RULLCA contains a discussion of why it does not contain series provisions. The Note states that, with regard to 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 panoply of unanswered questions, what types of disclosures must be made when a membership interest is subject to securities law?
Whether RULLCA’s omission of series provisions will have any impact on states’ decisions to enact series legislation remains to be seen. Many states have attempted to establish themselves as the most desirable jurisdiction in which to form an LLC.93 There is much state revenue to be gained from business filings and in the current economic recession, it is likely that the potential to increase state revenues will be a more important factor in the enactment of series LLC statutes than the fact that series provisions were not included in RULLCA.

J. Series Termination and Winding Up

The termination and winding up of a series within an LLC does not impact other series within the LLC nor does it cause the LLC to dissolve.94 Delaware provides two default provisions governing the dissociation of a member from a series. First, if a series member assigns all of his interest in a series, the member is no longer associated with that series and can not exercise any rights or powers with that series. Second, the assignment of the member’s interest in one series does not terminate that series, or cause that member to lose membership in any other series or membership in the LLC.95

Under the Delaware LLC default rules, an LLC faces dissolution when it no longer has a member.96 This default rule does not apply to a series; a series does not “depend for its existence on a member associated with the series.”97 Of course, the termination of the LLC also serves to terminate the series within the LLC.98

93 Illinois has taken the lead in providing for the separateness of each series within an LLC by explicitly providing that the LLC may choose to have each of its series treated as a separate entity. 805 ILCS 180/137-40(b) (2009). However, Delaware shortly thereafter amended its series LLC statutes in 2007 to provide that a series has the capacity to contract and hold property in its own name as well as to hold title to assets, grant liens and security interest, and sue and be sued. Del. Code tit. 6, § 18-215(e) (2009). Interestingly, although Delaware includes a series within the definition of a person, the statutes do not use the word “entity” in describing a series. See Ann Conaway, Business Review of the Delaware Series: Good Practice for the Informed (2009), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1097645. The recent Iowa series LLC statutes provide that a series “shall be treated as a separate entity to the extent set forth in the certificate of organization.” Iowa Code § 489.1201.3 (2009).

97 See Symonds & O’Toole, supra note 54.
V. USING SERIES LLCs FOR HOLDING REAL PROPERTY AND FOR REAL ESTATE VENTURES: SPECIAL ISSUES

LLCs have become the preferred entity for real estate ventures. Usually a separate LLC is formed to hold each parcel of real estate property or each real estate venture. It seems only logical for most enterprises that real estate properties and projects be segregated into separate series but remain part of a single LLC. Careful thought should precede the decision by real estate enterprises to form series LLCs.

Presently, series LLCs are being formed to hold multiple parcels of real estate. Each real estate property is held in a separate LLC in order to provide a firewall of liability protection around each property. Each series can also have different investors and managers to reflect the business relationship of the participants prior to placing the property into a series.

In some situations, it may be legally sound to take properties that are currently being held in separate LLCs and move them into a series LLC, with each property being held in a separate series. In many, if not most cases, holding single properties in separate LLCs is the more prudent choice.

Large commercial real estate ventures, including developers, property managers, etc., could utilize a series LLC to hold each property or real estate project instead of creating separate LLCs for each project. Still, using series LLCs for more complex real estate ventures raises many concerns. Until legislatures, courts, and the IRS address many of these unresolved issues, the use of series LLCs is best suited to the holding of real property rather than the development, construction, and management of real estate.

A. Single Purpose Entities (Bankruptcy-Remote Entities)

It is common for lenders to require borrowers to create single purpose entities (SPEs) to own properties that are acquired with borrowed funds. Generally, an SPE is created to achieve temporary objectives, primarily to isolate financial risk. A special purpose remote entity is often required to be a Delaware single-member LLC and be qualified to do business in the state in which the property is located. This structure requires engaging a registered agent, and often the lender requires a legal opinion as to the validity and good standing of the SPE and as to certain bankruptcy matters.

99 These entities are also referred to as “special purpose entities” and “bankruptcy remote entities.”

100 SPE limited partnerships are also used in mortgage loan transactions, usually typically consisting of one general partner and limited partners. Often lenders require all general partners of the SPE limited partnership be structured as SPEs or as single-member LLCs, thus reducing the risk of a general partner becoming insolvent, and possibly causing the dissolution of the SPE LP. See generally CCH’S PARTNERSHIP TAX PLANNING AND PRACTICE ¶ 6987 (2008).

The key requirements of an SPE are that it is unlikely to become insolvent as a result of its own activities and is adequately insulated from the consequences of a related party’s insolvency. Typical SPEs are required to: (1) restrict the objectives and the powers of the SPE to ensure cash flow; (2) adopt debt limitations; (3) prohibit reorganizations (i.e., mergers or consolidations); (4) provide for an independent director whose authority may be required to file a voluntary bankruptcy or amendments to the articles of organization; (5) adopt separateness covenants to prevent veil piercing; and (6) adopt entity specific characteristics, such as providing for a springing member to insure a single-member LLC continues upon the death of the single member.  

Currently, “securitized lenders do not recognize Series LLCs as single-purpose entities.”

B. Real Estate Financing for a Series LLC

In the event that a real estate LLC or one of its series seeks outside financing, a lender may seek the property or assets of another series as security (cross-collateralization). Whether pledging the interests in one series for a loan made to another series would result in the loss of the liability limitation for both series is an open question. However, cross-collateralization among the series blurs the line of separateness for each series. Until there are some court decisions on this issue, the best practice would be not to allow cross-collateralization among the series in the LLC or among the LLC and any of its series to ensure the legal separateness and limited liability of the LLC and each series.

C. Good-Standing Certificates and Attorney Opinion Letters

In addition to lenders providing loans to an LLC that is an SPE and requiring the LLC to provide a good-standing certificate, it is likely that there will be other creditors, suppliers, and parties entering contracts with the real estate LLC and, preferably with its series. A series is able to receive a good-standing certificate in Illinois, and presumably in Iowa. Series in other states definitely have a problem providing legal authority that they are duly formed and in good standing under the laws of the state in which they were organized.

It is very common for an LLC to obtain an attorney opinion letter stating that the LLC was duly formed. In fact, many third parties dealing with an LLC would prefer to rely on an attorney opinion letter as to the legal validity of the LLC. Whether an attorney would issue such an opinion letter for a series, especially in a state where the series can not obtain a good-standing certificate, is an open question.

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D. Bankruptcy Issues Involving Real Estate Series LLCs

In any high risk venture, including real estate development projects and ventures, financial insolvency and the potential for bankruptcy should be addressed when the business entity is being formed.\textsuperscript{104} Perhaps the greatest unknown in establishing a series LLC is how a court will treat a financially insolvent series that is in bankruptcy. To date, there is no assurance that a bankruptcy court will recognize a series as a separate entity and allow it to file bankruptcy, separate from the LLC. Of course, a bankruptcy court should allow an individual series to file bankruptcy, if the court correctly construes the state law that provides for the establishment of independent and separate series within the LLC, especially if the series are organized under the Illinois or Iowa statutes. But courts have gotten it wrong before.

The primary concern, assuming a bankruptcy court will allow the bankruptcy of a single series, is whether a real estate series is more likely to be subject to substantial consolidation than a series within an LLC that has little in common with the other series. For example, is an LLC with two series, one series holding title to the property and one series developing the property that becomes insolvent, more likely to face a judicial ruling that the series should be consolidated for bankruptcy purposes than an LLC with two series that are unrelated, such an mutual fund investment series and a real estate investment series?\textsuperscript{105}

Further complicating this issue is the possibility that the LLC members may not be members of each series. Assume series one holds title to the property and includes all LLC members but series two, which is developing the property, includes only some of the members. If series two becomes insolvent and is facing bankruptcy, the fact that a court may join series one will have a negative impact on series one members who had nothing to do with series two. LLC members, who were not involved in series two, did not stand to gain from the endeavors of series two; yet, they may still be subject to economic loss if a court consolidates the two series and holds that the assets of series one must be used to pay the debts of series two.

In the event that a series LLC, with only two series, one holding title to property and another developing the property, faced consolidation in bankruptcy court, would it not follow that the LLC itself might be consolidated into the

\textsuperscript{104} Legal and tax professionals often find it difficult to get their clients, who are excited about a new business venture and want only to get the business entity up and running, to focus on the issues involved if the business fails.

\textsuperscript{105} Even a series LLC that leases a single property and forms two series, one series to conduct the theater business on the property and another series to conduct the restaurant business on the property, may have a better chance of avoiding consolidation in bankruptcy than a series in which the title to the property is in one series and the development and construction of the property is in another series. In the event that subcontractors are unpaid and the property development becomes economically unfeasible, a court’s decision that equitable principles demand that the subcontractors should be able to add the series holding title to the property as a defendant would not seem unreasonable. The substantial consolidation issue is one that should be carefully considered before forming a real estate series LLC. However, even if a court recognized and respected the separateness of a series holding title to a property and a series developing a property, subcontractors would still have a remedy against the series holding title to the property under the mechanic’s liens provisions and judicial foreclosure statutes, which exist in every state.
bankruptcy, especially if the LLC had assets? Such a judicial consolidation would result in the LLC being treated as if the series had never existed.

For this author, the most serious unknown regarding series LLCs is whether courts will respect the separateness of each series in the event that one of the series becomes insolvent. This crucial issue is unlikely to arise as long as each of the series is financially solvent. Thus, the gravity of this issue magnifies when a higher risk business, such as real estate development and construction, is involved. In the current economic environment, it may not be too long before a bankruptcy court confronts this issue and provides guidance to all of us on how series will be treated.

**E. Ease of Forming Separate “Entities” for Real Estate Ventures**

Forming a series LLC basically involves three things: (1) allocating LLC property, obligations and assets and a subsequent allocation in the operating agreement of a member, manager, or membership interest with managerial authority and rights to receive profits and losses from the property in whatever manner desired; (2) including a method in the operating agreement to maintain separate and distinct records concerning the allocation of the LLC property, profits, losses, or other distributions; and (3) providing notice of the limitation on liabilities in the LLC’s certificate of formation.106

The notice of limitations that must be set forth in the LLC’s certificate of formation does not require any specific mention of any series within the LLC.107 Thus, an LLC planning on using series may (and should) give notice of the limitation of liabilities of its series, even if the LLC has yet to establish any series. The fact that the LLC’s certificate of formation is filed with the secretary of state constitutes notice to others that there is a limitation of liability with regards to any series within the LLC.108

A real estate venture that included multiple properties, projects, or different types of activities would be able to form a single LLC, with multiple series and by declaring itself a series LLC in accordance with statutory requirements governing the LLC’s certificate of formation, obtain the liability protection and, ideally, the separateness that normally requires the creation of a number of different entities or subsidiaries. As the LLC expanded to include additional real estate ventures, the LLC could simply create an additional series within the LLC to hold the property or the project, without the need to deal with the complexities of creating a new entity.109

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107 See, e.g., id.
108 See, e.g., id.
109 This is currently the situation under Delaware law as Delaware does not require a public filing (other than the original LLC certificate of formation) for any series. In addition, Delaware requires no separate filing fees in connection with a series. Del. Code tit. 6, § 18-215(b) (2009). See also, Brian R. Fons, Serious About Series LLCs, CBA Rec. 46 (Apr. 2007) (discussing cost savings possibilities using a series LLC as compared to forming separate LLCs); Jacob Stein, Advanced Asset Protection and Tax Planning With LLCs, L.A. Law 17 (June 2006) (discussing potential tax return cost advantages to using series LLCs).
F. Ease of Terminating a Real Estate Series When a Venture is Complete

The ease of forming a series within an LLC when the LLC undertakes a new real estate venture is fully complemented by the ease of terminating a series when it is no longer needed. Real estate developers involved in multiple projects can place those projects within separate series and terminate and wind up a series when the project within the series is finished. The process for terminating and winding up a series is similar to that of terminating and winding up an LLC. A key advantage to terminating the series as compared to terminating the LLC is that the real estate venture can continue operating within the LLC structure. A series LLC provides real estate ventures with an easy way to maintain continuous business operations, including new projects, even as it is winding up other parts of the business.

VI. Hypotheticals

**Example 1:** Husband and wife own a personal residence on a lake and also own the three adjoining properties and houses, which they rent out to tourists. For an additional fee, husband and wife also rent out their boat, jet skis, and snowmobiles to tourists who rent one of their properties. Currently, husband and wife have not formed a business entity of any type and simply declare the income (profit) from the rental activities on their own joint tax return. There are no mortgages on any of the properties, all of the properties have adequate insurance, and it is highly unlikely that husband and wife would ever need to file personal bankruptcy. After ten years of making their living from these rental activities, husband and wife are now concerned about their personal liability.

Because the properties do not have existing mortgages, there is no concern that transferring the properties to an LLC or to separate series within an LLC will trigger a provision in the loan agreement allowing the lender to call in the loan or requiring the owners to refinance. Liability insurance is never an adequate substitute for the creation of a limited liability entity.

How husband and wife have reported past income and should report future income from the rental activities is beyond the scope of this article, but federal and state tax issues should also be considered.

Husband and wife have no personal liability protection for their real estate business activities. Prior to the enactment of series LLC statutes, a legal practitioner would likely have suggested placing each of the rental properties, as well as the personal residence, into separate LLCs. Operating a high-risk rental business, such

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110 See, e.g., id. § 18-215(l).
111 Some states still require that an LLC have a “business purpose” and so, in those states, it may not be possible to place a personal residence into an LLC.
as leasing boats, jet-skis, or snowmobiles should be segregated from the other rental activities and conducted within a separate LLC.

As a practical matter, it may be difficult to convince husband and wife that after years of conducting these business activities without any problems, it is in their best interest to now create five separate business entities (LLCs). The costs and requirements for forming and operating five different LLCs may lead husband and wife to decide to continue their real estate activities as they have done previously. Provided the properties that husband and wife own are located in a state that has enacted “full” series statutes, this is probably an ideal real estate situation in which to recommend the formation of a series LLC.

In fact, it may be easier for husband and wife to understand and accept forming one entity, a series LLC, which separates each property or rental activity into a shielded cell and limits the liability for each property or activity to the assets of that property or activity (i.e., a separate series). State filing fees are likely to be similar (or slightly less) than the costs of forming separate LLCs. However, the cost of drafting separate and unique operating agreements for each series should not be necessary. The possibility that husband and wife would fail to treat each series with the same separateness that they would if each property or activity were placed in a separate LLC is remote. Finally, any potential legal issues or lawsuits will likely be determined under state law. The fact that the real estate series LLC is operated in a state that has “full” series LLC statutes strongly suggests that state courts will respect the letter and the intent of those statutes.

Example 2: Real estate development company with multiple projects. The LLC has five series and is developing five properties, each property held in a different series. One project has run into significant problems, including environmental issues, which have resulted in large fines and a series of suits against the LLC. The LLC decides to abandon that project and files for bankruptcy for that one series. The other four development projects are near completion, and all four of them will be very profitable for the LLC. The LLC is using many of the same suppliers and subcontractors on all five projects. The LLC pays all suppliers and subcontractors through the completion of the four projects, but many of these same suppliers and subcontractors are not paid for materials and work on the fifth project and are listed on the bankruptcy petition.

Would a bankruptcy court respect the separateness of the series filing for bankruptcy or would it look at the substantial profit that the LLC made from its other four series and hold that the LLC must

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112 See supra text accompanying notes 55-57.
113 Husband and wife are likely to be joint owners of each of the properties and rental activities and so one operating agreement should be applicable to each series.
pay all suppliers and subcontractors from the overall earnings of the LLC? Would it be a different result if some LLC members held interests in some of the series but not all of the series, or if they had different shares of interest in each series?

As a general rule, bankruptcy courts are disposed to recognize and respect the separate identities of related entities, particularly when applying the law of jurisdictions where the form of organization is authorized by state law. In states where series LLCs are explicitly recognized, it is probable that a bankruptcy court would recognize the separate identities of the five series, much as it would recognize the separate identities of subsidiary corporations with a common parent. The fact that some but not others of the series are profitable is not a particularly significant fact, in and of itself. Where suppliers and subcontractors have recourse to creditor’s remedies under state law, such as filing for mechanic’s liens, the equitable merits of the creditors’ argument for exposing the non-debtor series’ assets to satisfy their claims against the debtor series would be even less persuasive. That the makeup of the ownership of the several series differs would tend to support recognizing the entities as separate for purposes of the claims of creditors, but that is not a dispositive factor. Obviously, if the five series are managed and operated in such a way that the separate identities of the series would be disregarded on traditional veil-piercing or alter ego principles, then of course the court would be expected to consider those facts.

**Example 3:** A member with a significant interest in two of the series, and a much lesser interest in the other three series has a charging order against his LLC interest. The LLC opts to make distributions only from the series in which the member with the charging order against him has a negligible interest, which allows the member greater leverage in compromising the amount that he owes the creditor who has the charging order. The creditor with the charging order is only entitled to the member’s economic interest (i.e., distributions that the member is entitled to receive) and has none of the member’s other rights (i.e., management rights or other rights of membership). Would a court force distributions from the other series or at least examine whether the LLC had a legitimate business reason for making distributions from some series but not others?

Distributions from related entities normally are not subject to avoidance by a court, unless those distributions represent preferential payments or fraudulent transfers. The payments in this example would appear to involve neither. There is an equitable doctrine known as marshaling of assets, which posits there where a creditor has both secured and unsecured claims against a debtor, against whom other creditors have only unsecured claims, the creditor must satisfy his claim first from the property against which his claim is secured. The purpose is to assure to the extent possible that all creditors receive at least some distribution from the common debtor’s property.
This example is not analogous to that kind of situation, but it is at least conceivable that a court might examine the equities underlying the distributions. The distributions almost certainly would be immune from avoidance to the extent they are made for a legitimate business purpose. Courts rarely will look behind an ostensible or at least plausible business purpose, unless the transfers clearly are made for some purely pretextual reason.

**Example 4:** All of the LLC’s members have interests in each of the five series. Four of the five series are successful real estate development projects and profitable, but the fifth project requires an additional investment beyond what the LLC members are able to raise. The members decide to seek additional investors for the fifth series, but they do not want new LLC members who would be actively involved in the operations of, or decision-making about, the project. (Assume the LLC and each series is manager-managed by the terms of its operating agreement and each current member has been named a manager). They members are advised that seeking this type of investor is akin to bringing in limited partners. Thus, they are likely to be subject to securities registration and regulation. Will they be able to register the single series with the SEC (since the investors only have economic interest in that series) or will they need to register the LLC, since the investors will be LLC members with no management rights and expecting profits solely from the efforts of the managing members.

In the vast majority of cases, it is not feasible, practical, or advisable to register an offering made to a small group of investors. If the offering cannot qualify for exemption from registration under federal and state law, then it may not be practical to offer the interests to the new investors at all. Generally speaking, several components of a common or related offering are treated independently for purposes of registration, provided there was no common enterprise, no single plan of financing, and no single issuer attempting to evade the registration requirements of the securities laws. That does not appear to be the case here, so the new offering could probably be registered as a stand-alone offering. Registration of an offering of securities makes the securities more marketable, so it would be advantageous for the existing members to register the LLC’s securities, since their interests would become more valuable as a result of registration. If only the interests of the new investors were registered, those interests may well be more marketable, hence more valuable, than the interests of the existing members in the LLC.

**Example 5:** Real estate development company is developing an apartment complex and an industrial park. It creates three series for each project: (1) a series that contains the actual development and construction activities; (2) a series that holds title to the property;
and (3) a series that contains the property management company, which will handle leasing and maintenance of the property. After completing the construction of the apartment complex, the LLC decides that it wants to limit its activities to commercial and industrial real estate ventures and shed itself of the apartment complex and its related residential property activities.

This is a situation where a series LLC offers some clear advantages over forming separate LLCs for each aspect of the real estate venture. The LLC can simply terminate and wind up the series that developed and constructed the apartment complex because that activity is complete.\textsuperscript{114} The LLC could also sell the apartment complex held in series two and terminate the property management series as well.\textsuperscript{115} Under Delaware law, this could all be done without having to terminate the LLC or provide the state with additional filings.

In addition, when the LLC began a new real estate venture it could create three new series to perform each of these functions (or however many series it needed). Again, under Delaware law, this is easily accomplished without any requirement to file new entity documents with the state. The ease of forming and terminating series within an LLC is likely to be a key factor leading multi-faceted real estate ventures to eventually use a series LLC as its entity of choice.

\textbf{VII. CONCLUSION: SERIES LLCs ARE “IDEAL” ENTITIES FOR REAL ESTATE HOLDINGS AND VENTURES}

Series LLCs are the “ideal” entity for multiple real estate holdings or multi-faceted real estate ventures. If the rapid evolution of LLCs, including a vast body of law that developed and provided practitioners with confidence in forming LLCs, is any indication, it will not be long before series LLCs are used as regularly as LLCs are today. Real estate holdings and ventures will be able to use series LLCs to incorporate new projects, holdings, and other related endeavors within the confines of a single LLC, and with a simple way to create and terminate series as the need arises.

Although series LLCs are the “ideal” entity for real estate holdings and ventures, the reality is that there are still too many uncertainties, which weigh in favor of proceeding cautiously before forming a real estate series LLC. Although practitioners should be concerned with issues such as federal taxation, foreign state recognition of series, and financing, the issue of insolvency and whether a court will recognize the separateness of each series looms large. It is this issue, more than any other, which weighs against forming a real estate series LLC at this time.

\textsuperscript{114} A series operating agreement may specify an occurrence that would cause the series to terminate, such as the completion of the construction of the apartment complex. See e.g., Del. Code tit. 6, § 18-801 (2009).

\textsuperscript{115} The law does not prevent a single series from selling its assets. However, as of the date of this publication, Delaware’s series LLC statutes do not have provisions that specifically allow for the mergers of series.
Prior to the IRS issuing the check-the-box regulations, practitioners were reluctant to use LLCs. However, once those regulations were issued, LLCs became the entity of choice for many types of businesses. The recently issued proposed regulations on the tax treatment of series LLCs\textsuperscript{116} should result in practitioners being more comfortable encouraging clients to consider using series LLCs. As courts begin to address some of the legal uncertainties, there will be a rapid acceleration in the use of series LLCs for new real estate ventures as well as a move among existing real estate ventures, which currently operate through separate entities, to consolidate their business activities within the framework of a series LLC.

\textsuperscript{116} See supra note 84 and accompanying text.