Pros and Cons of the Series LLC

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Texas is one of about 16 states that permit the use of series limited liability companies (“LLC”). Under the series LLC structure, an LLC (referred to here as the “master LLC”) can create separate series to hold different assets that may or may not be under common ownership and/or management with the master LLC or any other series. The series LLC structure has two main advantages. The first is its potential to compartmentalize liabilities: as long as certain conditions are met, the assets of each series are shielded from the liabilities of the other series and the master LLC. Second, the series LLC structure can reduce costs and streamline administration because, in Texas at least, only the master LLC must file a certificate of formation, pay the filing fee, and file annual reports, and, in some cases, only the master LLC may be required to file tax returns. But while a series LLC as a form of business entity may have many benefits, there are also some negatives that may not make it the right fit in all circumstances. This article reviews the basics of the Texas series LLC structure and the reasons why it may (or may not) be the right form of entity in a given situation.

In Texas, a series LLC is formed in the same way as any other LLC, *i.e.*, by filing a certificate of formation with the Texas Secretary of State and adopting a company agreement. However, in order for an LLC to be able to form series, the certificate of formation and the company agreement of the LLC must include statements that “(1) the debts, liabilities, obligations, and expenses incurred, contracted for, or otherwise existing with respect to a particular series will be enforceable against the assets of that series only, and not against the assets of any other series or the LLC generally, and (2) none of the debts, liabilities, obligations, and expenses incurred, contracted for, or otherwise existing with respect to the limited liability company generally or any other series will be enforceable against the assets of a particular series.”[1] In other words, no series will be liable for the debts of any other series or of the master LLC. Simply making the required statements in the certificate of formation and company agreement will not, however, automatically segregate and contain liabilities. The law goes on to state that the liability protections will apply only if “the records maintained for [a] particular series account for the assets associated with that series separately from the other assets of the company or any other series.”[2] In other words, the master LLC and each series must maintain separate books and records.

In addition to the potential liability protections, an advantage of the series LLC structure is its great flexibility. Each series within an LLC may have its own members, managers, membership interests, assets, and purpose. The assets associated with a series may be held “in the name of the series, in the name of the limited liability company, through a nominee, or otherwise.”[3] The Texas statute also gives a series the power and capacity to, in its own name, sue and be sued; enter into contracts; acquire, sell, and hold title to assets, including real property; grant liens and security interests in assets of the series; and “exercise such powers or privileges as may be necessary or appropriate to conduct its business or attain its purposes.”[4]

Because assets and bookkeeping must be maintained separately for each series, the series LLC structure will work best where the assets of each series and their respective costs, expenses, and revenue streams can be tracked separately without great difficulty. For example, interests in oil and gas wells, where the revenue stream from each well can be separately tracked without much difficulty, could be held in different series of the same LLC. The same holds true for separate real estate assets. Even though separate books must be maintained for each series, there may be instances when one or more series created by a master LLC would be a disregarded entity for federal income tax purposes and would not have to file separate federal income tax returns.

The advantages of the series LLC structure are clear. One series LLC can provide the same benefits as multiple traditional LLCs but without the multiple filings, fees, annual reports, and in some cases, tax returns that would come with traditional LLCs. So what's not to like? In a word, uncertainty.

Uncertainties surrounding the series LLC arise in part from the fact that the series LLC is still a relatively new form of business entity. The strength of its liability protections and the legal ramifications of the relationships of the series to each other and to the master LLC have not been tested to any great extent by litigation. In addition, only about one-third of US states have adopted the series LLC structure. Whether the courts of a non-series LLC state would respect the liability shields of a series LLC is not known. Furthermore, the states that have adopted the series LLC structure have not done so in a uniform manner. Some states, such as Texas and Delaware, do not require any public filing to record the formation of a series by a master LLC, while others, like Illinois, do. Therefore, a state that either does not recognize the series LLC structure or that imposes more onerous requirements on series LLCs might not respect the series of an out-of-state LLC.

Alphonse v. Arch Bay Holdings, LLC, 548 F. App'x 979 (5th Cir. 2013), demonstrates the uncertainties arising from state law issues and the relative newness of the series LLC structure. Arch Bay Holdings, LLC was a Delaware series LLC. One of its series, Series 2010B, owned a loan secured by a mortgage on Alphonse's Louisiana home. When Alphonse's home was sold at a foreclosure sale, Alphonse sued Arch Bay under the Louisiana Unfair Trade Practices Act. A lower court had dismissed the case, in part because Delaware law determined Arch Bay's liability, and under Delaware law, Series 2010B was the real party in interest, not Arch Bay. The Fifth Circuit Court of Appeals, however, reversed the dismissal. As the court explained, the law of the state of incorporation of a business entity, Delaware in this case, normally determines issues relating to the internal affairs of an entity, but different principles might apply where the rights of third parties like Alphonse are at issue. Characterizing treatment of a series LLC as a "novel and complex" matter of state law, the court held that Louisiana law should be applied to determine whether Arch Bay or Series 2010B was the proper party. The question remains unanswered.

Other uncertainties include treatment of the series LLC as borrowers, under bankruptcy law, and under the Uniform Commercial Code ("UCC"). If a series LLC is a borrower, must the lender inspect the borrower's books and records to make sure that separate books are maintained for each series? On the other hand, if a loan is to be secured by all assets of a borrower that is a series LLC, should the lender require that the liability protections of the separate series be waived? If a master LLC files bankruptcy, will its series be pulled into the bankruptcy? Conversely, if a series files bankruptcy, will the master LLC and/or the other series be pulled in?   As for the UCC, in states where the formation of a series does not require a public filing, a series does not fit within the UCC definition of "debtor." If a series owns assets that secure a debt, who should be named as debtor on the UCC-1 financing statement that must be filed to perfect the lender's security interest? If the series is named as debtor, is the lender perfected?   Texas recently amended its UCC statute so that the definition of "person," which is incorporated in the definition of debtor, includes "a particular series of a for-profit entity."[5] But not every state that has adopted the series LLC structure has done so.

In conclusion, there are pros and cons to consider when deciding whether the series LLC is the best entity structure for a given situation. Weighing in favor of the series LLC are its tremendous flexibility and streamlined administration. Weighing against are the uncertainties, particularly if claims could arise under the laws of a state other than that in which the series LLC was formed.

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[1] Texas Business Organizations Code, Section 101.602(a)

[2] Texas Business Organizations Code, Section 101.602(b)(1)

[3] Texas Business Organizations Code, Section 101.603(a)

[4] Texas Business Organizations Code, Section 101.603(a)

[5] Texas Business and Commerce Code, Section 1.201(b)(27)

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