

At Glacier Speed, the Fastest Growing Entity of Choice, the Series LLC?

Alright, perhaps you did not catch the irony in the title but the subject of Limited Liability Companies (“LLC”) is or is becoming the hot topic of discussion for businesses, entrepreneurs and corporate attorneys considering the most advantageous legal structure their respective businesses or clients should undertake.¹ The oxymoron of “fastest” and “glacier” involves the difference between the current popularity of LLC’s since its introduction in 1977² and the plodding pace at which a new structure, the “Series LLC”,³ has taken since its first introduction in Delaware in 1996. Delaware amended its Limited Liability Company Act and became the first to introduce a promising new corporate structure known as the Series LLC.⁴ While the LLC is currently the entity of choice, the Series LLC, with its structural benefits and cost savings, has the potential of becoming more popular than the conventional LLC.

A look at the structure will place into perspective the advantages of a Series LLC.⁵ Even with advantages and promise of savings, a Series LLC is not for the faint hearted. As discussed later, there are some unresolved matters one must consider prior to incorporating a Series LLC.⁶

I. Limited Liability Company (“LLC”)

LLC’s were first introduced to the United States in 1997.⁷ An LLC is often described as a cross between a partnership and a corporation. The LLC structure provides liability protection like that of a corporation with the advantage of being treated like a partnership. In 1998 the IRS granted LLC’s “pass through” status, i.e. check the box company.⁸ One appealing aspects of the LLC structure is its’ “freedom of contract” provision authorized by statute and incorporated into the company’s operating agreement.⁹

The simplification and flexible administrative procedures have resulted in the LLC becoming the structure of choice. Different than the partnership model and the corporate share and/or percentage based models, profit distribution in an LLC is more flexible as members have the freedom to contract for a different profit distribution formula. In a General Partnership the rule regarding profit distribution is 50/50. A C-Corp, Close Corp and S-Corp structure generally divides profits in accordance with the respective shares or percentage of ownership. The profits of an LLC, while generally distributed in accordance with the percentage ownership held by the company’s members, the members can contract for an alternate distribution method so long as it is provided for in the operating agreement and signed by the members.

¹ See, The Quick Inc. Guide Forming an LLC, pg. 3, paragraph 5. There are certainly more considerations to take into account when electing a corporate structure and many of which depend upon the types and objectives of each particular business. Discussion of each individual factor leading to the right corporate structure is beyond the intent of this article.

In Pennsylvania LLCs are increasingly the entity of choice due to both the perception and fact that they are simple, less expensive to create and easier to administer. However, it is incumbent upon the members to be diligent in respecting the corporate form. See: http://www.peacockkeller.com/news/peacock_tales_oct04/03.html

In Illinois since the state first recognized Limited Liability Companies, there has been an explosion of businesses electing to that the form of an LLC. See: <http://www.dcba.org/brief/janissue/2006/art30106.htm>

Tennessee, in 2005, passed a slimmed down version of their LLC Act in order to increase its appeal. See: <http://www.bizjournals.com/memphis/stories/2006/02/06/story7.html?page=2>

² All though Pennsylvania, New Jersey, Michigan and Ohio enacted “limited partnership associations” or “partnership associations”, it was not until 1977 that Wyoming became the first state to enact a true LLC act. See: *LLC History* at www.llc-reporter.com

³ Del. Code Ann. Tit. 6, §18-215(a) and (b). Delaware in 1996 was the first state to enact a Series LLC statute. See: The Delaware Series LLC, F. Pileggi and G. Conaway, July 26, 2005, pg. 3.

⁴ Eight states have enacted Series LLC statutes, Delaware, Illinois, Iowa, Nevada, Oklahoma, Tennessee, Utah and Wisconsin. See: State and Local Tax Bulletin, Bradley, Arant, Rose & White, LLP, December 16, 2006, pg. 2.

⁵ I will use the Delaware Series LLC’s as the point of reference. Of the eight states that have amended their Limited Liability Company Acts, their Series LLC statutes have been patterned after Delaware’s statute.

⁶ This caveat is based upon some of the unresolved issues and lack of a body of law regarding certain issues. This article will take a look at some of these issues.

⁷ http://www.activefilings.com/en/information/faq_llc.htm

⁸ *Id.*

⁹ Del. Code Ann. Tit. 6, §18-1101(b); 15 Pa.C.S. § 8916(b)

The C-Corp, as mentioned earlier, is more complex and requires formal meetings, the recording of minutes for the Board meetings and documenting major corporate acts through Resolutions. With an LLC, the structure requires neither the recording of minutes nor making of resolutions and is thereby much simpler to operate. In an LLC the members have the option of managing the business or appointing a manager or managers. The managers are similar to the officers in a corporation.

The perceived and some real disadvantages are: First, a Corporation can have a perpetual existence and live forever. An LLC, in most states and in general, is dissolved upon a member becoming bankrupt or executing an assignment for the benefit of creditors or the death, retirement, insanity, resignation, expulsion or dissolution of a member or the occurrence of any other event that terminates the continued membership of a member in the company. In Delaware and Pennsylvania an LLC, identical to a corporation, can elect to have a “perpetual existence.”¹⁰ In Pennsylvania an amendment to the LLC Act made in 2001, allows the avoidance of dissolution upon a member’s disassociation, if within 180 days following the event all or a majority of members vote to avoid dissolution.¹¹ This vote presumes that the LLC would desire to provide for its continuation even as a single member LLC to the maximum extent possible.¹²

Another disadvantage exists in the inability of an LLC to go public. Businesses with plans to take the company public may consider this factor as a reason for electing the C Corp as its structure. One of several reasons an LLC cannot go public is that an LLC does not have “stock ownership” like a C-Corp. In a company that will require more than 30¹³ or 75¹⁴ stockholders, unlike the Close Corp or S Corp, the C-Corp is the only structure that allows the company to have an unlimited number of stockholders and use an IPO to raise financing. The observance of formalities of a corporation, such as stockholders and directors meetings, minutes, officers and director elections are more preferable and manageable a process for running large shareholder owned companies. Also with these formalities the operations of the company are more transparent than the operations of an LLC.

A somewhat related concern raised in one article, discusses an LLC’s inability to issue employee shares in the company.¹⁵ Given the ability of an LLC to issue certificates representing ownership in an LLC, I am not certain this remains a legitimate concern.¹⁶ For example, in a Delaware LLC, the LLC Agreement may provide for classes or groups of members having rights, powers and duties.¹⁷ As well, a class or group of members could be created that have no voting rights. Also a Delaware Series LLC can create and have different classes of ownership, voting and non-voting.¹⁸ In a Series LLC, the company could create an equity compensation program in one of its multiple divisions. Under such a program, the company could give key employees in each series an equity interest that is tied to that particular series only. This would thereby reward employees of a productive division and protects them from the potential downside of another division.¹⁹

II. Series LLC (“SLLC”)

Delaware has consistently been at the forefront with respect to corporate law. In 1996, Delaware became the “first state”, no pun intended, to enact a statute allowing an LLC to designate a “Series” of specified property or operations with separate business purposes or investment objectives.²⁰ The amendment to the Delaware Limited Liability Act (“DLA”) allows the particular debts, liabilities and obligations relating to a particular series to be enforceable only against the assets of that particular series and not against the assets of the SLLC generally or any other series within the SLLC. The concept is

¹⁰ Del. Code Ann. Tit. 6, §18-801(a)(1); 15 Pa.C.S. § 8971(b)

¹¹ 15 Pa.C.S. § 8971(a)(4)

¹² 15 Pa.C.S. § 8971(a)(4), See also 15 Pa.C.S. § 8971(b)

¹³ The limited number of shareholders in Delaware and Pennsylvania’s Close Corporations, *supra*.

¹⁴ 75 is the limitation on the number of S Corp shareholders with the American Jobs Creation Act, *supra*.

¹⁵ See *Limited Liability Company 101*, Darrell Zahorsky, <http://sbinformation.about.com/cs/ownership1/a/LLC.htm>

¹⁶ 15 Pa.C.S. § 8916 et seq.; Del. Code Ann Tit. 6, §18-101(7)

¹⁷ See §18-302 et seq.

¹⁸ Del. Code Ann. Tit. 6, §18-302. Classes and voting.

¹⁹ Delaware Series LLC, Article by Mayer & Riser, PLLC

²⁰ Del. Code Ann. Tit. 6, §18-215 et seq.

similar to segregated portfolio companies and protected cell companies designed for the mutual fund and captive insurance industries in Bermuda, Guernsey, the Cayman Islands, Mauritius and Belize.²¹ The islands built an attractive structure for mutual funds and captive insurance companies using a “Theory of Separating Assets”.

Each series is essentially a separate “cell” or “mini-LLC” within the LLC itself. Each cell or series can have separate members, managers, assets and liabilities, and business interests.²² It is the LLC and not the series which is treated as the legal entity under SLLC statutes. However, in order to receive this protection the SLLC must respect the series structure and observe the statutory rules.

Protection of series assets from an enforcement action against the assets of the SLLC or any other series, an SLLC must confirm and observe the following:

- 1) provide on the face of the certificate of formation notice of the establishment of one or more series;²³
- 2) maintain separate and distinct records for each series;²⁴
- 3) account for series assets separately from the other assets of the SLLC or any other series;²⁵ and
- 4) Operating Agreement must designate one or more series of interest.²⁶

Two advantages with the SLLC, consistent with LLC benefits in general, are the freedom of contract and flexibility.²⁷ The SLLC can create numerous series within the SLLC to accomplish numerous diverse business objectives and/or hold title to real estate separately. The Operating Agreement can provide for the formation and creation of classes or groups of members or managers that are not a part of any other series. In the ultimate form of flexibility, the SLLC agreement can, without the vote or approval of any member or manager or class or group of members or managers, take action and/or amend the SLLC agreement.²⁸ This aspect would not to be an appealing aspect to a public company’s shareholders.

Equally important is the fact that any event that causes a member to cease to be associated with a series will not, in and of itself, cause the member to cease to be associated with any other series or terminate the member’s interest in the SLLC. Further, a member’s disassociation with a series will not effect the limitation on the liabilities of that series, even if the member was the last surviving member associated with the particular series.²⁹ This amendment to DLLA radically changes how a LLC, as an entity, can separate and protect assets.

III. Theory of Separating Assets

Different assets present different types of risks. For example, a gas station presents a distinct and different type of risk than say a rental property. However, if one person owned both assets, his or her assets may be better protected by having them held by separate legal entities. Segregating “high risk” and “low risk” assets into separate entities is always a good idea. With respect to lines of business that an entity may engage in, the separation of high and low risk lines may also be a good idea.

Separating assets by creating individual entities is akin to building a firewall between the assets so that the creditors of one asset are limited in their legal recourse to pursue only that particular entity’s assets. Ideally, every distinct business or major business asset should be segregated. For example, someone with

²¹ Legal and Title-Insurance Issues in Limited Liability Company Real Estate Transactions, John Murray, 2003, pg. 45

²² Del. Code Ann. Tit. 6, §18-215(d)

²³ Del. Code Ann. Tit. 6, §18-215(b)

²⁴ *Id.*

²⁵ *Id.*

²⁶ Del. Code Ann. Tit. 6, §18-215(a)

²⁷ Del. Code Ann. Tit. 6, §18-1101(b)

²⁸ Del. Code Ann. Tit. 6, §18-215(d)

²⁹ Del. Code Ann. Tit. 6, §18-215(j)

multiple rental properties should have multiple legal entities, one for each property. However, this is not always practical due to the administrative costs and government fees that are associated with forming individual companies.

The concept of segregating assets is not restricted to the SLLC and in fact is very similar to the function of segregated portfolio companies (“SPC”) or protected cell companies (“PPC”) in Bermuda, Guernsey, the Cayman Island, Mauritius and Belize.³⁰ Captive insurance companies have gone to these off-shore locations seeking the advantages and protections offered through an SPC or PPC. An SPC or PPC in these jurisdictions are known as “cellular” companies.³¹ Both are statutory creatures designed to segregate the assets and liabilities of insurance companies desiring to introduce new lines of business and build a ring-fence around the performance of the other lines of business.

The objective of the SPC and PCC are similar to that of the Series LLC. Both the SPC and PCC are single corporate legal entities with the statutory right to segregate assets and liabilities within one company. The assets and liabilities of each “cell” or “portfolio” are legally separated and there is no joint liability. This statutory creation eliminates concerns and the risk of cross liability.³² Much like the SLLC, the SPC and PPC, are easy and cost-effective ways that reduce complexity and recognize administrative cost savings. Perhaps if a significant number of states or all states amend their Limited Liability Company Acts thereby allowing the creation of series within a LLC, more mutual funds and captive insurance companies would elect to conduct their business on-shore rather than off-shore.

IV. Costs and Savings

How much can the SLLC save for a company with ten (10) wholly owned subsidiaries?³³ Compare both Pennsylvania and Delaware with Delaware’s Series LLC costs. The figures include filing fees, filing service, fictitious name, and projected legal and accounting fees for each state to set-up each entity. Not listed are the ten separate federal and state tax returns and gross receipts taxes.³⁴ Over a course of years, which is not factored below, are the yearly costs associated with each individual LLC.

Delaware LLC	Pennsylvania LLC	Series LLC (DE)
Certificate of Formation \$90 Certified copy \$30 24 hr. filing \$50 10 x \$170 = \$1,700	Certificate of Formation \$125 Fictitious Name \$70 10 x \$195 = \$1,950	Certificate of Formation \$170 1 x \$170 = \$170
Franchise Taxes - \$200 (Yearly) 10 x \$200 = \$2,000	Annual Registration - \$380 (Yearly) 10 x \$380 = \$3,800	Franchise Taxes - \$200 (Yearly) 1 x \$200 = \$200
Legal Fees \$1,500 / \$3,000 10 x \$1,500 = 15,000	Legal Fees \$1,500 / \$3,000 10 x \$1,500 - \$15,000	Legal Fees \$3,000 1 x \$3,000 = \$3,000
Accounting \$500 10 x \$500 = \$5,000	Accounting \$500 10 x \$500 = \$5,000	Accounting \$500 1 x \$500 = \$500
Gross Receipts (Depends)	Gross Receipts (Depends)	Gross Receipts (Depends)
Total Estimate: \$23,700	Total Estimate: \$25,750	Total Estimate: \$3,870

³⁰ Delaware Series LLC, Article by Mayer & Riser, PLLC; Also see: [Insuring on Shore Risk Through Segregated Cells – Will Our Firewalls Hold Up](http://www.captive.com/newsstand/CharlestonCaptiveMgt/SegregatedCells.html), John J. O’Brien, JD, CLU, CPCU, <http://www.captive.com/newsstand/CharlestonCaptiveMgt/SegregatedCells.html>

³¹ [Cayman Island: Segregated Portfolio Companies and Insurance](http://www.mondaq.com/article.asp?articleid=30339&lastestnews=1), Richard Addlestone, September 29, 2005: <http://www.mondaq.com/article.asp?articleid=30339&lastestnews=1>

³² *Id.*

³³ While ten may seem high, there are companies that have 18 or more wholly-owned corporate subsidiaries.

³⁴ The legal and accounting figures are based upon averages; the filing fees and franchise are the latest figures for each state. Other miscellaneous fees have not been included. It is easy to discern the savings with the use of the SLLC as apposed to forming 10 separate LLCs.

V. Rise of the SLLC

Since Delaware's creation in 1996, eight states have enacted SLLC legislation. Again, while LLC Acts are not being amended at a blistering pace, the up-tick of activity in states amending their respective LLC Act represents an increased belief in the theory of segregating assets and providing this type of protection to businesses.

Delaware³⁵ was the first to amend its Limited Liability Company Act which was followed by Illinois,³⁶ Iowa,³⁷ Wisconsin,³⁸ Oklahoma,³⁹ Nevada,⁴⁰ Tennessee,⁴¹ and Utah.⁴² The last state's Governor, Jon M. Huntsman, Jr. signed House Bill No. 127 into law on March 10, 2006. The bill modified Utah's Revised Limited Liability Company Act (Title 48, Chapter 2c) and now provides for the creation of a series LLC. The amendment is due to become effective on May 1, 2006.

All eight states, in amending their respective LLC Acts, considered the limitations associated with the conventional LLC in terms of asset protection along with the financial burdens associated with creating multiple LLCs. Each state chose to enact a business tool that not only makes sense but allows an LLC to have the protections of multiple separate legal entities without the administrative, legal, and governmental costs normally incurred in creating multiple entities.

The benefits enjoyed with a SLLC in each state include the following:

- Tremendous cost savings (See section II, page 9, above) by setting up a parent subsidiary type of structure and insulating the assets from creditors;
- Potential of superior protection over multiple LLCs because the assets are segregated;
- Easier administrative procedures for adding an additional series, through a simple amendment to the LLC agreement and no filing requirement with the state;
- Simple dissolution of a series without affecting the LLC or any other series; and
- Tax free transfer of real property within the LLC.

World activities, including outsourcing and the tremendous loss by states of manufacturing jobs to business operations in overseas operations such as China and India, to just name a few, certainly makes it understandable why many states are interested in making their state more attractive for a businesses to locate and operate. The attractiveness of an SLLC is that it's a vehicle through which companies can set up diverse business interests and build a fire wall around the ownership interest, operations and assets. The objectives behind the SLLC statutes are not to create tax loop holes or provide a means by which a business can avoid taxes. However, the objective is to provide asset protection and the ability to have numerous business interests operating within one corporate structure. For states that subscribe to this reasoning, the prospects of job creation and greater business opportunities, along with revenue generation from the increased business activities within the state are obvious.

If the SLLC is strategically structured with a sound business plan, it can be an incredible tool to the company and its ability to compete competitively in the fast paced and changing world markets. Today a company's ability to react to rapidly changing conditions and not being hindered by complying with

³⁵ Del. Code Ann. Tit. 6, §18-215 et seq.

³⁶ 805 ILCS 180/37-40

³⁷ IA Code § 490A.305

³⁸ WS Stat. Ann. §183.0504

³⁹ 18 Okl. Stat. Ann. §2005(B)

⁴⁰ NV Rev. Stat. Ann. §86.161-1(e)

⁴¹ TN Code Ann. §48-249-309(a) & (b) et. seq.

⁴² On March 10, 2006, Utah Governor Jon M. Huntsman, Jr. signed House Bill No. 127 into law. The bill modifies the Utah Revised Limited Liability Company Act (Title 48, Chapter 2c) to provide for creation of a series LLC and becomes effective on May 1, 2006.

complex internal corporate procedures is the appeal of the LLC and SLLC. However, before you rush out and elect an SLLC corporate structure, there are certain unresolved questions that need to be considered.

VI. Unresolved Questions:

The main unresolved issues with the SLLC are:

1. Are the asset(s) owned by a series prohibited from being utilized by another series or the LLC in general?
2. Can a series hold title to assets in the series name or must the assets be designated only on the records?
3. Does the notice requirements set forth in the statutes provide enough protection, to avoid a creditor's claim of a lack of or no notice?
4. Will the statutory limitation on liability provisions be honored in non-SLLC states?
5. Will the IRS consider the general LLC and the series as separate partnerships for tax purposes?
6. Could a series be used to avoid state taxes?
7. Are there property sales and purchases which will, upon transfer, create issues for state taxing authorities?
8. Will the limitation on liabilities of a series be applicable in the case of environmental contamination?
9. What will be the effect and/or application of the bankruptcy laws on a series of an LLC?

Although these questions remain unanswered at this time regarding the administration and implementation of the SLLC, it should be remembered that it was not that long ago that the viability and protection provided by traditional LLC was also looked upon with skepticism.

CONCLUSION

We live in a world that is, due in part to the success of the internet, a global business market. With the ability to market and sell services and goods around the world with the click of a mouse, it has had a tremendous impact on how and where businesses operate. In the United States we have sustained a loss of manufacturing jobs at staggering rates. The Economic Policy Institute⁴³ reported that the manufacturing sector lost more than three million jobs between 1998 and 2003, with 2.7 million lost since the immediate pre-recession year of 2000. Today in the United States we are at the lowest levels of manufacturing job employment since 1958.⁴⁴

There is considerable debate surrounding the reason for the United State's loss of manufacturing jobs. While some attribute the phenomenon to the U.S. trade deficits that grew to 234 billion between 2000 and 2005.⁴⁵ Others attribute the loss to a "natural phenomenon" that cannot be arrested.⁴⁶ Independent of what has caused this staggering loss of manufacturing jobs; it directly impacts both the U.S. and various state economies.

⁴³ http://www.epinet.org/content.cfm/briefingpapers_bp149

⁴⁴ *Id.*

⁴⁵ <http://www.epi.org/content.cfm/bp171>

⁴⁶ http://www.epinet.org/content.cfm/briefingpapers_bp149

What should be done? This reminds me of the story about the Lion and Gazelle. A Gazelle wakes up every morning and knows that in order to survive it must be able to outrun the fastest Lion. A Lion wakes up each morning and knows that in order for it to survive it must out run the slowest Gazelle. Regardless of whether you are a Lion or a Gazelle, each morning when you wake-up, you better start running. Like the Lion and Gazelle, every city and state within United States knows that in order to develop and retain jobs it must become creative in its ability to attract businesses to expand or to locate in their respective cities or state. Regardless of whether you are the City of Philadelphia or the Commonwealth of Pennsylvania, with each new morning it had better start running with new and creative ideas.

States that have amended their LLC Acts have taken a step towards improving the business climate within their respective state. In giving a business the opportunity to conduct different and various business activities under the umbrella of one corporate structure, affords it the opportunity of not only attracting new businesses to the state but giving current businesses the opportunity to easily and cost effectively expand their operations into other lines of business. The SLLC has a tremendous potential for generating not only additional jobs through the growth of new business and the expansion of existing ones, but each state would benefit from the increased revenues those same businesses would bring to the state.

On the legal front, yes there remain unresolved questions. However, those questions should not prevent states and businesses from taking advantage of the benefits associated with this new and exciting business structure. As with the unanswered questions that were develop when the LLC structure was new, the approach should be well thought-out and the benefits and risks fully understood and considered. Professionals, such as lawyers, accountants, and business strategy consultants, should be involved in the review of this type of structure for a particular business. Like the LLC, the SLLC can, in my opinion, become a marketing tool for states to both attract and retain businesses in their respective states.

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