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Taking the Series LLC Seriously: Why States Should Adopt This Innovative Business Form

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TAKING THE SERIES LLC SERIOUSLY: WHY STATES SHOULD ADOPT THIS INNOVATIVE BUSINESS FORM

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ABSTRACT

The series LLC has gained slow, consistent popularity among states over the past two decades, and this popularity will only continue to grow with the upcoming publication of a Uniform Act. Despite this increase in adoption, there is a dearth of academic literature advising state policymakers of the benefits and risks of adopting the entity form. The series LLC could provide a much-needed economic boost for small businesses in this tough economic climate, growing the state tax base, while increasing efficiency, and decreasing bureaucratic red tape. The series LLC statute ultimately adopted by states should balance pro-creditor and pro-business interests to the fullest extent possible. This balance is best achieved by (1) constructing the statute to minimize risks in bankruptcy for businesses by incorporating many of the equity factors of substantive consolidation into the language, while (2) encouraging bankruptcy courts to adopt a rebuttable presumption of "separateness" to allow creditors a chance to rebut the presumption and recover.

I. INTRODUCTION

The series LLC offers policymakers an inexpensive way to promote economic growth and new business formation. Many states are still recovering from the post-2008 economic slump, and are looking for a way to stimulate their local economies. With the anticipated 2017 release of the final version of the Limited Liability Company Protected Series Act,[1] there has never been a better time to consider the many potential benefits of adopting the series LLC (SLLC).

The SLLC is one of the newest iterations of the unincorporated business form. The entity consists of a parent LLC, which forms cell companies, or "series," separate from the parent and one another, to insulate risks, liabilities, and assets. Although the series form could be adopted by any business, it provides the most obvious benefits to small businesses by allowing these smaller, local entrepreneurs to save thousands annually in state filing fees. In the aggregate, this could add up to millions of dollars. These savings can then be reinvested in opening a storefront, expanding business, and generally growing the local

[1] Anticipated July 2017, the National Conference of Commissioners on Uniform State Laws will release the final version of the Limited Liability Company Protected Series Act. [hereinafter Ltd. Liab. Co. Protected Series Act (July 2016 Draft)], https://perma.cc/HMC9-T9ZY.

economy. Or, foreign LLCs may be more likely to enter the market as an SLLC, thereby increasing out-of-state investment.

This article is the first to specifically address state policymakers, by suggesting the optimal statutory scheme for adoption that borrows equity factors from bankruptcy to minimize risks to businesses electing to use this form.[2] Additionally, this article is the first to articulate how a series LLC should be treated in substantive consolidation once in bankruptcy.[3] Much of the previous scholarship in this area has simply posed the many unanswered questions about series LLCs like choice of law, and tax or bankruptcy treatment.[4] Ultimately, most of this scholarship warns practitioners against the SLLC lest he or she unintentionally ill-advise a client to adopt a risky, untested business form.[5] But how will these questions ever be answered if more states do

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[2] *See* discussion *infra* Part III.

[3] Generally, most articles about series LLCs will mention the potential risk that substantive consolidation poses. However, a few articles have listed several options for treatment by courts (not just in substantive consolidation, but also in veil piercing and other litigation). *See* Steven J. Boyajian, *Code to Code, Series LLCs: Can a Series File for Bankruptcy and What If It Does*?, 35-3 ABIJ 24 (March 2016) (explaining eligibility under the Bankruptcy Code and some important facets of series LLCs that may complicate bankruptcy proceedings).

[4] *See* Sandra Mertens, Note, *Symposium: Who Owns Your Body? Series Limited Liability Companies: A Possible Solution to Multiple LLCs,* 84 CHI.-KENT L. REV. 271 (2009); Bernie K. Ray, Comment, *Respecting the Concept and Limited Liability of a Series LLC in Texas*, 42 ST. MARY'S L.J. 501 (2011); Bruce H. White, *Utah Series LLC –The Risk of Use Continues To Be Uncertain*, 29 UTAH BAR J. 24 (2016); Terence Floyd Cuff, *Delaware Series LLCs and Transaction Practice – Part 3*, 39 REAL EST. TAX'N 35 (2011); Justin T. Fezzi, Comment, *Third Time's a Charm: How The Uniform Law Commission Can Fit Series LLCs Into the Uniform Limited Liability Company Act*, 58 ST. LOUIS L.J. 911 (2014).

[5] Mertens, *supra* note 4, at 311 ("[T]he plethora of unanswered questions surrounding series LLCs, the potential pitfalls, and the possibility to lose everything puts attorneys in an impossible predicament. . . . However, at this time, the concept is too ambiguous and incoherent."); Ray, *supra* note 4, at 547 ("Until binding decisions resolve these concerns, practitioners who find a series LLC an appropriate business form for their clients should proceed with caution and diligently heed a number of recommendations."); White, *supra* note 4, at 28 ("A lack of case law, particularly under the Bankruptcy Code, should be reason enough for one to not take the risk of using the Series LLC form."); Cuff, *supra* note 4, at 35 ("Anyone involved with series LLCs should proceed with caution."); Fezzi, *supra* note 4, at 915 ("Largest contributor to their lack of growth has been the glut of uncertainties regarding the treatment of series

not adopt, and more clients do not select, the SLLC form for their businesses?[6]

States should adopt the series LLC business form to promote economic growth and efficiency, and decrease red tape, but maintain a balance between pro-creditor and pro-business interests. Without the wealth generated by healthy business, there is no tax-base to support important social welfare programs. The importance of balancing pro-business interests with pro-creditor protections in economic policies such as this cannot be overstated. However, if structured correctly the SLLC balances these seemingly competitive interests by incentivizing individual series to protect their creditors.[7]

The SLLC statute should be structured in such a way as to include the maximum number of equity factors from substantive consolidation doctrine in bankruptcy.[8] Some of these factors are included in previous statutory language, like requiring separate record keeping for each series.[9] But, including even more could increase protection for businesses should they find themselves declaring bankruptcy.[10] For example, separating the members of the parent LLC from any of its protected series.[11]

A rebuttable presumption of "separateness" for each protected series within the SLLC offers the best opportunity to balance pro-creditor interests in the bankruptcy context.[12] Uncertainty of SLLC treatment in bankruptcy proceedings hinders the adoption of the business form.[13] A rebuttable presumption provides a solution to this uncertainty: if a series has "dotted its I's and crossed its T's" throughout formation, annual filing, and bookkeeping, and the SLLC is not misusing its corporate

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LLCs.").

[6] *See* Wendell Gingrich, *Series LLCs: The Problem of the Chicken and the Egg*, 4 ENTREPEN. BUS. L.J. 193, 311(2009).

[7] Michael E. Fink, Comment, *The Series LLC: Suggestions for Surviving Some Series Uncertainties*, 72 U. PITT. L. REV. 597, 613-14 (2011) ("[T]he willingness or unwillingness of creditors to do with business with [the series LLC] would be the most telling.").

[8] Meaning, if courts will look to consider whether bank accounts are commingled, include the inverse into the statutory language by requiring that businesses maintain separate accounts.

[9] *See, e.g.* DEL. CODE ANN. tit. 6 §18-215(b).

[10] *See infra* Part III.B.

[11] *See infra* Part III.B.i

[12] *See infra* Part IV.C.

[13] *See* Wendell Gingrich, *Series LLCs: The Problem of the Chicken and the Egg*, 4 ENTREPEN. BUS. L.J. 193 (2009).

form, it will be rewarded with the rebuttable presumption of "separateness." This allows creditors to recover from the individual protected series in which they invested, or to punish the whole SLLC for wrongdoing in formation. This rebuttable presumption holds true throughout analogous areas of the law like consolidated tax returns, and hedge funds.[14]

This article consists of five parts. Part I will discuss the origins and different statutory forms of the series LLC. Part II will provide background information about substantive consolidation doctrine, including an overview of previous scholarship, and a discussion of the limited case law indicating how a series LLC may be treated in bankruptcy proceedings. Part III will argue states should adopt the series LLC form with a statutory form that minimizes the likelihood the protected series would be substantively consolidated in bankruptcy. Part IV will argue bankruptcy courts should resolve the uncertainty regarding treatment of series LLC by adopting a rebuttable presumption of separateness.

II. Different Statutory Constructions of Series LLC Legislation Create Confusion Among Jurisdictions

Part I will trace the origins of the series LLC business form, through its first codification in Delaware in 1996 up through the present drafting of the Uniform Law Commission's Model Act. It will also briefly discuss the international usage of the SLLC, and the different names given to roughly the same business form across different nations

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A. The Series LLC: Origin, Form, and Function

Series LLCs are one of the newest, and potentially most important, innovations in corporate law in the past decade. The SLLC takes advantage of two types of internal liability shields: vertical and horizontal.[15] Vertical shields protect from piercing or consolidation from subsidiary to parent, where horizontal shields protect entities and associations from brother-to-sister piercing or consolidation.[16] Anecdotal evidence suggests that in states that have adopted the series LLC form, it

[14] *See infra* Part IV.C.
[15] *See* Ltd. Liab. Co. Protected Series Act (July 2016 Annual Meeting Draft), *supra* note 1.
[16] *Id.*

is increasingly popular.[17] "As of July 26, 2016 more than 26,000 protected series were active under Illinois law."[18] Or, in Delaware, it is estimated that between 1000-1500 series are currently in use.[19] Growing popularity is also evidenced by the number of states adopting the form, which in 2016 is now up to a total of 15 states.[20]

Although it is clear that the form *is* growing in popularity, the reasons behind that growth are unclear and often different from state-to-state. In fact, states are often adopting different variants of the law or tinkering with the type of statutory adoption.[21] The type of SLLC statute discussed in this paper is more analogous to that of Illinois or Delaware where an additional Act was adopted to create a new entity form with asset partitioning and internal liability protection. In states like Minnesota,[22] North Dakota,[23] and Wisconsin,[24] the word "series" does exist in their statutes. However, the word does not refer to asset partitioning or internal liability shields, rather it describes a type of ownership interest in a business resembling ownership interests in stock.[25]

Some growth in the SLLC form can be explained as the manifestation of interest in the affiliated-business form. Managers and owners have been crafting and operating affiliated, families of businesses for years now.[26] But often that form is only created through trial-and-error, with the help of an attorney, ad hoc over many years. The series

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17 *Id.* at 4.
18 *Id.*
19 *See supra* note 6.
20 Delaware was the first state to adopt the series LLC in 1996. The next state to adopt the form, Oklahoma, did not do so until 2004. After that, adoption took off rapidly, as Illinois, Nevada, and Tennessee adopted the form in 2005. In 2008, Iowa became the sixth state to adopt the series LLC, followed by Texas in 2009. Non-states have also indicated interest in series LLCs, as Puerto Rico adopted them in 2009, followed by the District of Columbia in 2011. In 2012, Kansas adopted the series form, followed by Missouri, Montana, and Utah in 2013. Alabama adopted the series LLC in 2014. Indiana is the most recent state to adopt the series LLC at the writing of this article, with their adoption of the form in 2016.
21 *See infra*, Part III.A.ii.
22 *See* MINN. STAT. § 302A.137 (2016)
23 *See* N.D. CENT. CODE § 10-32-02.55 (2016).
24 *See* WIS. STAT. 183.0504 (2016).
25 *See supra* note 1, at 4.
26 *See* Amanda, J. Bahena, Note, *Series LLCs: The Asset Protection Dream Machines?*, 35 IOWA J. CORP. L. 799, 802 (2016).

LLC offers the opportunity to easily start a group of affiliated businesses from the very beginning.[27] Further, much of the potential growth for the SLLC form is in the investment context.[28] The SLLC allows for greater regulatory efficiency, and less government red tape, as only one regulatory filing need be made on behalf of all the affiliated businesses represented, the benefits of which are most readily obvious in the investment context.[29]

i. Origins and Foundation

The SLLC is a newer iteration of the Limited Liability Company, containing two types of internal liability shields: vertical, and horizontal.[30] The form provides the same corporate-type liability protection with partnership-like tax treatment, plus the same contractual and organizational flexibility as the original LLC form.[31] In this new evolution however, managers and members can take full advantage of that archetypal LLC organizational flexibility by creating separate divisions or classes, called "series" with their own members, managers, interests, and business purposes.[32] SLLC statutes typically provide these series with separate judicial status; such as they can individually hold assets or contract for debt, in their own names.[33]

1. Mutual Funds, Massachusetts Trusts, and Hedge Funds

In 1996, Delaware officially adopted the SLLC business form, noting it is a creative derivation of the traditional mutual fund form into a corporate-type entity. A good example of the bridge between an SLLC and a mutual fund is the so-called "Massachusetts trust."[34]

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[27] *See* Ltd. Liab. Co. Protected Series Act (July 2016 Annual Meeting Draft), *supra* note 1.
[28] Justin T. Fezzi, Comment, *Third Time's A Charm: How the Uniform Law Commission Can Fit Series LLCs into the Uniform Limited Liability Company Act,* 58 ST. LOUIS L.J. 911, 914 (2014).
[29] *Id.*
[30] *See supra* note 1.
[31] Shannon L. Dawson, *Series LLC and Bankruptcy: When the Series Finds Itself in Trouble, Will It Need Its Parent to Bail It Out?,* 35 DEL. J. CORP. LAW 515 (2010).
[32] *Id.* at 516.
[33] *Id.*
[34] *Id.*

A *Massachusetts trust* is a business form in which an investor is a *grantor*, who entrusts management of the trust's assets to a *trustee*.[35] The investor/grantor's liability is limited to the investment, similar to a limited partnership.[36] These trusts can be formed in such a way that they too have *series*, and can be known as *series trusts*.[37] Organizationally, series trusts and series LLCs have much in common: separate pools of assets, and the limitation of: (1) shareholders to the assets of which they own a membership interest, (2) debts and obligations to an individual asset, and (3) voting rights to a particular series.[38] It may be instructive to look at how courts have treated these series trusts in past litigation. By implication that such series can elect their own tax status, they must be separate.[39] Logically, a single entity would not have multiple tax classifications within a single year, so it would be odd to aggregate the parent trust and its series trusts.[40]

In *National Securities Series-Industrial Stock Series v. Commissioner*, the court presumed "the series of a single investment trust would be classified as a distinct taxable entity."[41] The question in *National Securities Series* was whether amounts paid to shareholders on share redemption were preferential dividends, and therefore not includible as dividends paid for the calculation of a surtax credit.[42] The court ultimately held that the payments were not preferential dividends and were includible in the credit calculation,[43] implying that each plaintiff was a separate entity (from one another and the parent trust), because each was assessed a separate calculation of tax treatment.[44]

In 1984, the IRS issued a General Counsel Memorandum (GCM) resolving the question of whether a "Massachusetts" business trust consisted of one or three taxable unincorporated entities.[45] The "trust document authorized the establishment of separate investment portfolios, or funds, each of which was represented by a 'separate series of

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[35] *Id.*
[36] *See* Massachusetts Trust, CORNELL UNIVERSITY LAW SCHOOL, *available at* https://perma.cc/KVW7-GJ9P.
[37] Dawson, *supra* note 31, at 518.
[38] *Id.* at 529-35.
[39] I.R.S. Gen. Couns. Mem. 39,211 (Jan. 13, 1984).
[40] Dawson, *supra* note 31, at 530.
[41] Nat'l Sec. Series-Indus. Stock Series v. Comm'r, 13 T.C. 884, 885 (1949).
[42] *Id.*
[43] *Id.* at 889.
[44] Dawson, *supra* note 31, at 531.
[45] I.R.S. Gen. Couns. Mem. 39,211 (Jan. 13, 1984).

shares.'"[46] These series funds operated in ways much like a series LLC: (1) Each of these funds had different managers, investment objectives, assets, and shareholders;[47] (2) the liabilities and expenses of each fund were assessed only against the assets of that fund;[48] and, (3) voting matters applicable to one fund could only be voted on by the shareholders of said fund.[49] Based on these characteristics of the series trusts, the IRS found them to be taxable as separate entities.[50]

According to Shannon Dawson, this analogy is made less convincing when one looks to the differences between series trusts and series LLCs. In a trust, like the one referenced throughout the GCM, each individual trust had different ownership interests, unlike most series LLCs.[51] Series trusts have different management schemes, whereas in a series LLC the operating agreement may or may not alter the management scheme between series.[52] Series trusts are highly unlikely to engage in many joint activities, unlike a series LLC which often operates in various parts of the same, or connected, business.[53]

2. International Iterations

Interestingly, the series LLC is not only a Delaware/United States concept. Several other countries have them, or some variant, as well. Luxembourg established its variant of the series LLC, calling them "compartments" instead of "series."[54] Their statutory construction provides for the same internal liability shields, limiting creditors to the asset of their investment in the event of liquidation of that compartment.[55] Luxembourg actually stipulates as to the "separateness" of each compartment, declaring that each shall be treated as a separate entity in all instances excepting its formation documents.[56]

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[46] Dawson, *supra* note 31, at 532.
[47] I.R.S. Gen. Couns. Mem. 39,211 (Jan. 13, 1984).
[48] *Id.*
[49] *Id.*
[50] *Id.* ("[E]ach fund is a separate and distinct economic entity consisting of separate pools of assets and streams of earnings. . .. Under these circumstances, we believe that the funds shall be classified as separate taxable entities.").
[51] Dawson, *supra* note 31, at 533.
[52] *Id.*
[53] *Id.*
[54] Luxembourg Securitization Law of 2004 § 62(3).
[55] *Id.* at § 62(1), (2).
[56] *Id.* at § 62(3).

Other countries such as the Cayman Islands, the British Virgin Islands, Belize, Bermuda, Guernsey, and Mauritius all developed a variation of the "protected cell company" or "segregated portfolio company" much like Luxembourg or the Delaware.[57] Many see the series LLC as the next step in the evolutionary development of unincorporated entities, particularly within the confines of American corporate law.[58]

ii. Statutory Constructions

Although fifteen states have adopted the SLLC entity, none have truly adopted the series in the same way. This article will examine three main statutory constructions: Delaware, Illinois, and the forthcoming Model Act.

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57 *Id.*
58 Dominick T. Gattuso, *Series LLCS: Let's Give the Frog a Little Love*, 17 BUS. L. TODAY 33, 33 (July-Aug. 2008).

1. Delaware – 1996

Delaware is the origin of the series LLC concept, and as such, it is of preeminent importance in the discussion of a series LLC statutory structure. Delaware law states, "[a] limited liability company agreement may establish or provide for the establishment of [one] or more designated series of members, managers, limited liability company interests, or assets."[59] Each series may establish its own lawful business or investment purpose, "whether or not it is for profit,"[60] and is authorized with all the powers, duties, and rights of a limited liability company associated with its own individual assets, property, profits, or losses.[61] The Delaware SLLC statute imbues a series with the rights to contract, hold title, grant liens, and sue and be sued, in its own name.[62] One of the more innovative features of the SLLC is that the debts, obligations, liabilities, and expenses of the series are not enforceable against another series or the parent.[63] This separate liability protection is available provided that: (1) the assets held by one series are not commingled with the assets of another series, and (2) that notice of the limited liability nature of the series LLC form is set forth in the certificate of formation and the LLC agreement.[64]

Individual series can still maintain different classes of members or managers, with different rights, powers, and obligations, provided they are established in the LLC agreement.[65] One can be a member or manager for more than one series, and each series may have more than one member or manager.[66] The dissolution of the parent LLC will cause the termination of all its series; however, an individual series may be wound up without any effect on the parent or other series.[67] Interestingly, if the parent LLC becomes insolvent, that does not prevent a series from making a distribution.[68]

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[59] DEL. CODE. ANN. tit. 6, § 18-215(a) (2016).
[60] *Id.* at § 18-215(c).
[61] *Id.* at § 18-215(a).
[62] *Id.* at § 18-215(c).
[63] Dawson, *supra* note 31, at 519.
[64] DEL. CODE. ANN. tit. 6, §18-215(b).
[65] *See* Ltd. Liab. Co. Protected Series Act (July 2016 Annual Meeting Draft), *supra* note 1.
[66] DEL. CODE. ANN. tit. 6, § 18-215(g) (2016).
[67] *Id.* § 18-215(k).
[68] *Id.* § 18-215(i).

2. Illinois – 2005

Nine years later, Illinois adopted its own variation of the SLLC form, making some significant improvements on Delaware's statutory model. Illinois went so far as to provide that individual series exercise the powers of a limited liability company under Illinois law.[69] Each series requires its own separately filed "certificate of designation" to remain on file with the Secretary of State, containing the name of each series and its members and managers, to provide notice to potential creditors of the limited liability nature of the series.[70] Upon filing the certificate of designation, the series comes into being.[71] Once marked "filed," the certificate of designation provides conclusive evidence that all conditions precedent to formation were observed.

Illinois also allows the series to elect to: consolidate their taxpayer status to single entity, contract jointly, work cooperatively, or be treated as a single business for purposes of qualification to do business in this or any other state.[72] None of these elections affect the limited liability nature of the series, except where the series have specifically adopted joint liability by contract.[73]

3. Model Act – July 2016 Annual Meeting Draft

The National Conference of Commissioners on Uniform State Laws (NCCUSL) first integrated the concept of "series" provisions into the Uniform Statutory Trust Act in 2008.[74] From 2003 to 2006, the NCCUSL considered adding a series provision the Revised Uniform Limited Liability Company Act (RULLCA), but ultimately decided

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69 805 ILL. COMP. STAT. 180/37-40(b) (2010) ("A series with limited liability shall be treated as a separate entity to the extent set forth in the articles of organization. Each series with limited liability may, in its own name, contract, hold title to assets, grant security interests, sue and be sued and otherwise conduct business and exercise the powers of a limited liability company under this Act.")
70 805 ILL. COMP. STAT. 180/37-40(d) (2016).
71 *Id.*
72 805 ILL. COMP. STAT. 180/37-40(b) (2016).
73 *Id.*
74 *See* Mertens, *supra* note 4, at 305 (citing Unif. Statutory Trust Entity Act, Prefatory Note 2 (Annual Meeting Draft 2008)).

against it for seemingly "patriarchal" reasons.[75] Namely, that other states did not engage in as sophisticated business ventures as Delaware, and there was risk that business owners may misunderstand and misuse the series LLC form.[76] However, the growth and adoption of the series LLC continued, even among three jurisdictions that did adopt RULLCA.[77] Ultimately this led the NCCUSL to announce its formation of a Study Committee on Series of Unincorporated Business Entities in July of 2011.[78]

The Model Act is structured in such a way as to draw as many analogies as possible to existing limited liability law and simply "extrapolate" that law to apply to the series LLC form.[79] For example, because almost all limited liability company statutes provide for management by members, it follows that an SLLC would operate in an analogous way (management by associated members of that protected series).[80] A protected series is treated as though it were a separate limited liability company, and the default rules that come along with such treatment logically follow.[81]

Under the Model form, separate public filings are necessary to create each protected series.[82] Series are defined as legal persons.[83] The name of the protected series must include the name of the series limited liability company, much like Illinois.[84] The Model Act suggests using the abbreviation "P.S." or "PS" in the name as well. The Commentary below §202 in the Proposed Model Act (Version from July 2016) suggests the filing of the certificate of designation, coupled with the naming

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[75] *See* Fezzi, *supra* note 4, at 917.
[76] *Id. See also* Progress Report on the Revised Uniform Limited Liability Company Act (ULLCA II) March 2008.
[77] Iowa, Utah, and the District of Columbia all adopted RULLCA, but added series provisions to the uniform statutes on their books.
[78] Uniform Law Commission, *Annual Meeting of the Committee on Scope and Program*, (July 8, 2011), *available at* https://perma.cc/Z8JB-ZXG3.
[79] Ltd. Liab. Co. Protected Series Act (July 2016 Annual Meeting Draft), *supra* note 1, at 8.
[80] *Id.*
[81] *Id.* at §103. Examples of the default rules provided for in §103 are as follows: (1) associated members of a protected series is treated as members of an LLC, (2) a series manager is treated as a person managing a separate company, (3) a transferable interest of a protected series is treated as a transferable interest of a separate company. *Id.*
[82] *See* § 201(b).
[83] *See* § 102(7).
[84] *See* § 202. p

requirements, "provide substantial transparency."[85] It should then be a matter of public record if: (1) a limited liability company is a series limited liability company, and (2) a specific organization is a protected series.[86] Revealing also what protected series "belong" to a particular series LLC, or vice versa, upon searching.

One of the innovations of the NCCUSL's 2016 draft of the SLLC Uniform Act is to separate two related components of vertical liability: the non-liability rule and the non-recourse rule.[87] The non-liability refers to the separateness of protected series, in particular that one protected series is not liable for the debts of the series limited liability company or any of the other protected series.[88] The non-recourse rule states that "each associated asset of a protected series is shielded against collection efforts of judgment creditors of the series [LLC] or of any other protected series of the company,"[89] but that association is only accomplished by careful paperwork and record maintenance. Previous series LLC statutes have consolidated both of these pieces into the concept of vertical liability, but the proposed Model Act separates the non-recourse rule and reserves it as a "punishment" of sorts for a wrongdoing in formation or series/protected series management and operation.[90] The formulation adopted by the NCCUSL also "creates an additional vulnerability;" however, a judgment debtor might easily recover from an associated asset (should the asset fail the nonrecourse requirement) in addition to recovering against the protected series from which they have sued.[91]

B. Previous scholarship: Practitioners and Policymakers

When reviewing the previous literature about SLLCs, several things became readily apparent. First, SLLCs are being discussed almost exclusively in practitioner materials or state bar journals. They are

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[85] *See* Ltd. Liab. Co. Protected Series Act (July 2016 Annual Meeting Draft), *supra* note 1, at §202.
[86] *Id.*
[87] *Id.* at 6.
[88] *Id.* at § 401(a)(2).
[89] *Id.* at § 103 (emphasis omitted).
[90] *Id.* at 6 ("[A]n asset owned by a protected series but not properly associated with the protected series is up for grabs not only to a person asserting claims against the protected series but also to a claimant against the series limited liability company and a claimant against any other protected series of the company.").
[91] *Id.* at 8.

receiving relatively little treatment in academic literature, and then most of that literature is 6-8 years old. Second, and logically, the literature is written for a practitioner audience. Meaning, the articles are geared towards how to advise a client to the risks and benefits of using the SLLC form. Most articles generally conclude that the SLLC is too risky, has too many unanswered questions, and too many inconclusive answers, to advise a client to use it in good faith. As lawyers, no practitioner wants to advise a client to adopt an untested business form that may open that client up to untold and unforeseen liability.

The SLLC suffers from a classic chicken-and-egg problem: if states do not adopt the SLLC form, the lingering questions about them will not be answered.[92] But until the unresolved questions have some kind of resolution and more individuals indicate their intent to use the entity form, states postpone adoption of the form. This article will argue that states should adopt the SLLC form in its best possible form, to allow bankruptcy, and other, courts to begin resolving whatever leftover questions remain post-formation.[93]

There is a dearth of literature advising policymakers on the proper statutory form, application, and benefits of the SLLC form. This article will attempt to fill that void. State policymakers should adopt the version of the SLLC that best fits with the existing laws of their state to prevent undue confusion and unnecessary overlap between statutory provisions. These statutes should, ideally, include as many of the factors borrowed from substantive consolidation as possible to minimize the likelihood that an SLLC would be consolidated should it become insolvent – one of the largest risks to business owners with multiple business ventures. In this way, when a bankruptcy court finally reviews an SLLC case on the merits, the SLLC will have a strong presumption of separateness in entities, as with other families of unincorporated entities.

III. Bankruptcy Concerns, Like Substantive Consolidation, Hinder Adoption of the Series LLC Form

Part II provides background information on substantive consolidation doctrine in bankruptcy, and why it presents a unique risk to business owners wishing to form a series LLC. This section also gives an overview of existing literature about the SLLC in the bankruptcy context,

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[92] *See* Wendell Gingrich, *Series LLCs: The Problem of the Chicken and the Egg*, 4 ENTREPEN. BUS. L.J. 193 (2009).
[93] *See infra* Part III-IV.

and discusses the limited previous case law and IRS rulings on the "personhood" of series LLCs.

A. "Personhood" and the IRS Private Opinion Letter

Under the United States Bankruptcy Code, "only a person that resides or has domicile, a place of business, or property in the United States, or a municipality, may be a debtor" for bankruptcy purposes.[94] The definition of "person" includes an "individual, partnership, and corporation."[95] Despite extensive revision in 2005, the Code has never been amended to explicitly include limited liability companies under the definition of a "person."[96] However, case law indicates that LLCs should be, and are, treated as "persons" for bankruptcy purposes.[97] The question remains whether an individual series would be allowed to file for bankruptcy in its own right, in other words, is it a "person?" For example, if the Master LLC were required to file bankruptcy on behalf of Series 1, would the assets of all the other series also become part of the bankruptcy estate?[98] If so, this would destroy the very internal liability shields that make the series LLC form innovative and attractive. Even if a state statute explicitly establishes internal liability protection, preemption doctrine dictates that federal courts need not necessarily follow those state protections, particularly not equity-based bankruptcy courts.[99]

The first case to take up the issue of LLC's "personhood" for bankruptcy purposes was *In re ICLNDS Notes Acquisition, LLC* ("ICLNDS"), which filed voluntary bankruptcy under Chapter 7.[100] In that case, the court held that "corporations and partnerships are eligible

[94] 11 U.S.C. § 109(a) (2016).
[95] *Id.* at §101(4).
[96] *See* Dawson, *supra* note 31, at 521.
[97] *See, e.g., In re* ICLNDS Notes Acquisition, LLC, 259 B.R. 289, 292 (Bankr. N.D. Ohio 2001); *In re* KSM Props., LLC, 318 F.R. 712, 717 (B.A.P. 9th Cir. 2004); *In re* Midpoint Dev., LLC. 313 B.R. 486, 488-89 (W.D. Okla. 2004), *rev'd on other grounds*, No. 04-1509-R, slip op. at 7 (Banks. W.D. Okla. Fed. 3, 2005), *aff'd*, 466 F. 3d 1201 (10th Cir. 2006); *In re* Calhoun, 312 B.R. 380, 383 (Banks. N.D. Iowa 2004).
[98] Dawson, *supra* note 31, at 521.
[99] *See* Young v. United States, 535 U.S. 43, 50 (2002) ("[B]ankruptcy courts . . . are courts of equity and 'appl[y] the principles and rules of equity jurisprudence.'" (quoting Pepper v. Litton, 308 U.S. 295, 304 (1939))).
[100] *In re* ICLNDS Notes Acquisition, LLC, 259 B.R. 289 (Bankr. N.D. Ohio 2001).

to be debtors, and because an LLC draws its character from both of those forms of doing business, an LLC is similar enough to those entities," to file for bankruptcy.[101] In *ICLNDS,* the court relied on the fact that LLCs were legal entities that shared characteristics of other entities explicitly granted the ability to file,[102] particularly: (1) member-manager's shield from personal liability, (2) organization for any lawful purpose, (3) management in proportion to capital contribution/ownership interest, and (4) partnership-like tax status.[103] These characteristics may inform the likelihood that a series is found to be a "person" under the bankruptcy code. Most series LLC statutes are structured in such a way that they mimic or complement the structure of an LLC, which indicates that under the United States Bankruptcy Code a series would qualify as a person.[104]

In 2008, the IRS issued a private letter ruling concerning a "Massachusetts" trust operating a closed-end mutual fund that wished to convert to a Delaware SLLC.[105] The trustees divided the beneficial interests of the trust into several series, each with a separate portfolio.[106] The trust wanted to reorganize under Delaware law as an SLLC.[107] Once the trust liquidated, the shareholders of each trust portfolio would then be vested with a membership interest in the series. The operating agreement restricted the transferability of shares, each series would maintain its own investment objectives, and the profits/losses of each series would only be assessed against that series[108] – all the classic hallmarks of the SLLC form. When reorganizing, the series would have the opportunity to select whether they wished to be taxed as "Type D" (a single-member disregarded entity), "Type P" (a partnership), or "Type C" (an association taxable as a corporation).[109] The IRS confirmed each series could select its own tax status according to the scheme listed above.[110] Meaning, the IRS treats each series as a separate taxable entity.[111]

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[101] *Id.* at 293.
[102] *Id.* at 292-93.
[103] *Id.* at 292.
[104] *See supra*, Part I (A)(2).
[105] I.R.S. Priv. Ltr. Rul. 08-03-004 (Jan. 18, 2008).
[106] *Id.*
[107] *Id.*
[108] *Id.*
[109] *Id.*
[110] I.R.S. Priv. Ltr. Rul. 08-03-004 (Jan. 18, 2008).
[111] *Id.*

The IRS resolved the question of tax status for a Delaware SLLC under the Delaware Code, and which provides persuasive guidance to courts that series are likely "persons" under the bankruptcy code.

B. Primer: What is Substantive Consolidation?

To many state policymakers, or indeed many non-corporate attorneys, the word "substantive consolidation" may be relatively unknown or unclear. For clarity, this section will provide a brief primer on substantive consolidation: what it is, its origins, and the risks it poses for unwary business owners. A general working definition of the doctrine states that bankruptcy courts may choose to "consolidate the assets and liabilities of different legal entities" so that they are treated as if they were held by a single entity.[112] It is most easily explained as a kind of two-step process: first, the court looks to see whether the entities even qualify for substantive consolidation; if they do (or might), the court then moves to step two, to examine whether substantive consolidation is indeed proper for the creditors. There are several elements that are commonly used to test a substantive consolidation inquiry (*infra)*, but no one factor is determinative. "A combination of elements showing a substantial relationship among the debtors [entities] is a predicate to substantive consolidation, but the existence of such a relationship alone will not support substantive consolidation."[113]

Bankruptcy law is uniquely situated in the law, as it is bound by the federal Bankruptcy Code but at the same time, operates primarily as a court of equity. *Substantive consolidation* occupies that strange middle ground of bankruptcy law, as it is not statutorily granted but rather is a part of the federal common law "emanat[ing] from equity."[114] However, this equitable power does find its origin in the Bankruptcy Code, which explicitly grants to courts the ability to "merg[e] or consolidat[e]" assets and liabilities of the debtors with other persons.[115] In substantive consolidation, it is important to remember that the relationship between

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[112] 2-105 COLLIER'S ON BANKRUPTCY ¶ 105.09. The Third Circuit Court of Appeals defined substantive consolidation as "treat[ing] separate legal entities as if they were merged into a single survivor left with all the cumulative assets and liabilities (save for the inter-entity liabilities, which are erased)." *In re Owens Corning,* 419 F.3d 195, 205 (3rd Cir. 2005).
[113] 2-105 COLLIER'S ON BANKRUPTCY ¶ 105.09[a][ii][A].
[114] *In re* Owens Corning, 419 F.3d 195, 205 (3rd Cir. 2005).
[115] 11 U.S.C. §105(a).

the legal entities potentially being consolidated is much more important than the legal form of the entities.[116]

The effect of substantive consolidation on unsecured creditors and equity holders cannot be overstated. Normally, the separate creditors of each debtor would receive a different percentage recovery on their claims from the separate estates of the debtors.[117] However, the consolidation of the legal entities results in both unsecured creditors now receiving the same percentage recovery.[118] Meaning, the creditors of the one receiving the higher percentage recovery on their claims if the debtors were separate will be negatively affected by the consolidation.[119] Because bankruptcy courts are well aware of the potential harm they may inflict on creditors, substantive consolidation is considered a power to be rarely exercised.[120]

There is no set, prescribed legal standard for substantive consolidation. It is an ad hoc, fact-specific inquiry so there is little precedential value to previous substantive consolidation cases. The emerging standard of substantive consolidation, as stated by the 3rd Circuit in *In re Owens Corning* is what, in particular, presents such a potential risk to SLLCs.[121] In that case, the court created a test concerning the types of entities for whom substantive consolidation makes sense, namely those where: (1) prior to petitioning for bankruptcy, the separateness of the entities was significantly disregarded to the point that creditors treated them as a single entity; or (2) the assets and liabilities of the entities are so muddled that separating them would be prohibitively difficult and likely would end up damaging all creditors. The *Owens Corning* court was careful to note that to qualify under the

[116] 2-105 COLLIER'S ON BANKRUPTCY ¶ 105.09[c].
[117] *See* COLLIER' S, *supra* note 112, at 105.09.
[118] *Id.*
[119] *Id.*
[120] "[T]here appears to be nearly unanimous consensus that it is a remedy to be used 'sparingly.'" *In re* Owens Corning, 419 F.3d 195, 205-06 (3rd Cir. 2005); *see In re* Aguie/Restivo Baking Co. Ltd., 860 F.2d 515, 518 (2nd Cir. 1988); *see also* Wells Fargo Bank v. Sommers (*In re* Amco Ins.), 444 F.3d 690, n.5 (5th Cir. 2006); Alexander v. Compton (*In re* Bonham), 229 F.3d 750, 767 (9th Cir. 2000) (stating that "almost every other court has noted [substantive consolidation] should be used 'sparingly'") (citing *In re* Flora Mir Candy Co., 432 F.2d 1060, 1062-63 (2d. Cir. 1970)); FDIC v. Colonial Realty Co., 966 F.2d 57, 61, 26 C.B.C.2d 1687, 1693 (2d Cir. 1992); Chemical Bank New York Trust Co. v. Kheel, 369 F.2d 845, 847 (2d Cir. 1966).
[121] *Owens,* 419 F.3d at 195.

second rationale, the assets would have to be truly and hopelessly scrambled, and the threshold for such a mess is very high.[122]

Once the inquiry has moved past whether substantive consolidation is possible for these entities, the bankruptcy courts begins to look at a list of elements relating to the nature of the entities, their relationship, and their creditors themselves to determine if substantive consolidation is proper. These elements[123] include:

(1) Parent corporation owns all or a majority of the capital stock of the subsidiary;
(2) Parent and subsidiary have common officers and directors;
(3) Parent finances subsidiary;
(4) Parent is responsible for incorporation of subsidiary;
(5) Subsidiary has grossly inadequate capital;
(6) Parent pays salaries, expenses, or losses of subsidiaries;
(7) Subsidiary has substantially no business except with parent;
(8) Subsidiary has essentially no assets except for those conveyed by parent;
(9) Parent refers to subsidiary as department or division of parent;
(10) Director or officers do not act in interests of subsidiary, but take directions from parent;
(11) Formal legal requirements of the subsidiary as a separate and independent corporation are not observed.[124]
(12) Degree of difficulty in segregating and ascertaining individual assets and liabilities;
(13) Presence or absence of consolidated financial statement;
(14) Profitability of consolidation at a single physical location;
(15) Poor record-keeping or commingling of assets and business functions;
(16) Unity of interests and ownership between various corporate entities;
(17) Existence of parent and inter-corporate guarantees on loans; and,

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[122] *Id.* at 214.

[124] *In re* Tureaud, 45 B.R. 658, 662 (Bankr. N.D. Okla. 1985), *aff'd*, 14 C.B.C.2d 1131, 59 B.R. 973 (N.D. Okla. 1986) (citing Fish v. East, 114 F.2d 177 (10th Cir. 1940), and in *In re* Gulfco Inc. Corp., 593 F.2d 921 (10th Cir. 1979)).

(18) Transferring assets without formal observance of corporate formalities.[125]

Additionally, the "alter ego" theory is commonly mentioned in connection with substantive consolidation.[126] This term is used to refer to a group of affiliate entities that, like those elements listed above, have failed to observe some corporate formalities, but to the point where the entities are not "functionally distinct."[127] The corporation is merely the "alter ego" of its shareholder, used interchangeably. If it is apparent that one series is being used interchangeably with the parent series or another horizontal series, courts may consider them simply a unitary whole.

Over time, and as the case law of substantive consolidation has developed, courts have increasingly addressed concerns about the potential creditor prejudice that arises in substantive consolidation. Many courts now engage in a balancing analysis based on the *Snider Bros* decision, which essentially examines the common elements listed above, combined with equity factors. To summarize, first, a court determines if there is a substantial identity between the entities (using the common elements *supra*). Second, is consolidation necessary to prevent a harm or infer a benefit. Third, if a creditor objects, he must provide evidence that he did not rely on the separateness of the entities' credit. And fourth, there must be enough evidence available that the benefit counterbalances or far outweighs the harm.[128]

C. Previous Scholarship About Series LLCs and Substantive Consolidation

Most articles about the SLLC at least mention substantive consolidation as a recurring concern, but so far only two articles have

[125] (12) to (18) come from more recent trends in substantive consolidation case law. *In re* Vecco Constr. Indus., Inc., 2 C.B.C.2d 216, 219, 4 B.R. 407, 410 (Bankr. E.D. Va. 1980); *see also* Kapila v. S&G Fin. Servs., LLC (*In re* S&G Fin. Servs. of S. Fla., Inc.,), 451 F.R. 573, 583-84 (Bankr. S.D. Fla. 2011); *In re* Raymond Prof'l Grp., Inc. v. William A. Pop Co (*In re* Raymond Prof'l Grp., Inc.), 438 B.R. 130, 138 (Bankr. N.D. Ill. 2010); R2 Invs. LDC v. World Access, Inc. (*In re* World Access, Inc.), 301 B.R. 217, 272-74 (Bankr. N.D. Ill. 2003).

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[127] 2-105 COLLIER'S ON BANKRUPTCY ¶ 105.09[a][ii][A].

[128] *In re* Snider Bros., 18 B.R. 230, 234 (Bankr. D. Mass. 1982) (this test has been widely adopted in numerous courts see 2-105 COLLIER'S ON BANKRUPTCY ¶ P 105.09 at Fn. 60.

focused in-depth on the potential ramifications of the SLLC in bankruptcy, specifically whether an individual series can be a "person" under the bankruptcy code and Delaware law.[129] No article has attempted to articulate how substantive consolidation might work should an SLLC find itself in the midst of bankruptcy.[130]

This is one of the most important questions about the SLLC, as its very nature includes some of the elements listed above. For example, a parent SLLC "incorporates" or creates its subsidiary series; the separate legal status and documentation of a series and parent may not be all that substantial (in some states it may require no paperwork at all); or, some SLLCs may operate theoretically different components of a unitary business. However, there is a shift in substantive consolidation to consider the traditional elements more of a unitary whole in the greater balancing analysis, weighing them against prejudice to creditors, necessity of consolidation, and reliance by creditors on the separate credit of separate entities. [131]

This is where the SLLC may have a stronger argument that substantive consolidation is improper. If the statute is structured properly, the SLLC should give creditors plenty of notice that they are indeed investing in a "series" which is much more equitable to creditors than owning multiple LLCs (which they would be unlikely to know up front but could still be subject to consolidation later). Further, drafting the series LLC statute in such a way can minimize the "fit" with substantive consolidation elements. For example, including provisions requiring rigorous record-keeping for each individual series, and especially for inter-series transfers, and requiring each series to maintain its own accounts to prevent commingling of assets.

D. Case Law

i. Alphonse v. Arch Bay Holdings, Inc.

Glenn E. Alphonse's Louisiana home was foreclosed on in 2010, and rather than challenging the foreclosure itself or appealing in state court, Alphonse chose to sue in federal district court under the Louisiana

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[129] *See* Dawson, *supra* note 31, at 521; *see also* Boyajian, *supra* note 3.
[130] *See supra* note 3.
[131] J. Stephen Gilbert, Note, *Substantive Consolidation in Bankruptcy: A Primer*, 42 VAND. L. REV. 207, 216 (1990) ("Courts may ignore the presence or absence of certain factors in order to fashion relief equitably under consolidation.").

Unfair Trade Practices Act ("LUTPA").[132] He originally obtained his mortgage from WMC Mortgage Corporation, who later assigned it to the Delaware entity Arch Bay Holding LLC-Series 2010B.[133] Upon commencement of his federal district court action, Alphonse sued Arch Bay Holdings, LLC ("Arch Bay," the parent LLC) alleging Arch Bay "wrongfully seized and possessed his home through essentially fraudulent means."[134] Among other holdings, the district court determined that Alphonse's LUTPA claims against Arch Bay should be dismissed because Delaware law governs Arch Bay's liability, and under Delaware law, "Series 2010B is the real party in interest" to this suit, not Arch Bay.[135] In between the district court's decision and appeal, the Fifth Circuit decided *Truong v. Bank of America,* which Arch Bay argued nevertheless did not affect the outcome of the present facts "because of res judicata and Series 2010B's separate juridical status."[136]

On appeal, the Fifth Circuit asked "whether there exist[ed] sufficient 'identity of the parties' between Arch Bay (the parent company) and Series 2010B (the judgment creditor)."[137] "[T]he separate juridical status of a Series LLC . . . remains an open question."[138] And ultimately, the Court remanded the case because of an insufficiency of facts in the record to determine whether Series 2010B was truly a separate entity.[139] However, they did instruct the district court that its application of Delaware law may not have been correct because it is unclear whether the liability of a "series" is external or internal.[140] If it is an internal liability, the law of the state of incorporation governs those conflicts, whereas that same law does not necessarily govern conflicts regarding rights of third parties (external) to the LLC.[141] The Court held that dismissal was improper because the district court failed to evaluate the internal/external liability question under Louisiana law.[142]

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132 Alphonse v. Arch Bay Holdings, Inc., 548 Fed. Appx. 979, 981 (5th Cir. 2013).
133 *Id.* at 980.
134 *Id.*
135 *Id.* at 981. ("In other words, Alphonse sued the wrong defendant.").
136 *Id.* at 982.
137 *Id.* at 983.
138 *Id.* at 984.
139 *Id.*
140 *Id.* at 986.
141 *Id.* (quoting First Nat'l City Bank v. Banco Para El Comerico Exterior de Cuba, 462 U.S. 611 (1983)).
142 *Alphonse*, 548 Fed. Appx. at 986.

ii. GxG Mgmt. v. Young Bros. & Co., Inc.

Currently, the only case to ever address the treatment of a foreign SLLC in a non-SLLC jurisdiction is *GxG Management LLC v. Young Bros. & Co., Inc.*, although its holding is now slightly outdated.[143] A Maine federal district court applied Delaware law in determining whether a series of a Delaware SLLC could be joined as a party to a lawsuit in Maine.[144] In this case, the series form was being used to maintain and manage the affairs of the Goelet family including various family residences, and the boat they used to transport family members between those residences.[145] That boat experienced significant engine and hull problems, resulting in the retention of the Young Bros. & Co. for maintenance.[146]

Maine lacked an SLLC statute itself, but recognized a "special relationship" between a Delaware SLLC and its series.[147] In 2007, when the Court decided this case, Delaware did not have statutory language explicitly stating that a series has the capacity to sue and be sued.[148] The Court also raised the question of whether the parent LLC assigned all of its rights under the Young Bros. & Co. contract to its Series B.[149] In its reply brief, GxG Management, LLC stated that it was "not a separate entity from 'Series B" and "[did] not create a separate entity that stands alone for all purposes under Delaware law."[150] Without directly addressing the issue of separateness between a series and its parent SLLC, the court held the parent and series had a sufficient unity of interest, "such that neither could obtain a judgment against Young Bros. for these same events."[151]

Previous literature suggests this does not bode well for the future of the series LLC, as in this case, the Court essentially treated them as the same entity.[152] However, this is an incorrect generalization. The court never explicitly states it does not recognize "separateness" between the

[143] GxG Management LLC v. Young Bros. 7 Co., Inc., Civil No. 05-162-B-K, 2007 WL 551761 (D. Me. 2007).
[144] *Id.* at *7.
[145] *Id.* at *1.
[146] *Id.* at *4.
[147] *Id.* at *1.
[148] *Id.* at *7.
[149] *GxG Management LLC*, 2007 WL 551761 at *8 (no evidence was produced at trial to alleviate this concern).
[150] *Id.* at *7 (quoting Pl.'s reply at 4).
[151] *Id.* at *8.
[152] *See* Bahena, *supra* note 26, at 803.

parent and series.[153] Rather the court has reservations about the notion of "separateness," questions that remained unresolved based on the record.[154] This case spurred the Delaware legislature to amend its series LLC statute to explicitly stipulate the rights of series to sue and be sued in their own name,[155] thereby clarifying some of the court's reservations about the separateness of series.

IV. ARGUMENT: STATES SHOULD ADOPT A STATUTORY CONSTRUCTION OF THE SERIES LLC THAT MINIMIZES THE RISK OF SUBSTANTIVE CONSOLIDATION

Part III will argue states should adopt the SLLC business form to promote economic growth, decrease bureaucratic red tape, and incentivize the creation of new businesses. But, the SLLC should be adopted with a very specific statutory structure in mind: one that includes equity factors borrowed from substantive consolidation to minimize the risks SLLCs face in bankruptcy proceedings.

A. Economic Policy: Good for the State Economy

Currently, an individual could just operate several single-member LLCs to manage multiple businesses.[156] However, this does not necessarily accomplish the same end.[157] Facially, to the extent that an individual could operate multiple businesses, multiple LLCs operate much like an SLLC.[158] But, with multiple LLCs an individual is paying thousands of dollars annually in multiple filing fees with the Secretary of State's office and the administrative costs of preparing the multiple filing documents, the SLLC presents a clear advantage. Additionally, and often overlooked, it is important to point out that maintaining multiple single-member LLCs bears many of the same risks of veil-piercing and

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153 *GxG Management LLC*, 2007 WL 551761 at *8.
154 *Id.*
155 *See* DEL. CODE ANN. tit. 6 § 18-215(c) (West 2016).
156 Ltd. Liab. Co. Protected Series Act (July 2016 Annual Meeting Draft), *supra* note 1, at Prefatory Note ("For the most part, the legal and business relationships established through a protected series can also be established with various structures involving several limited liability companies.").
157 *See* Mertens, *supra* note 4, at 272.
158 *See* Fezzi, *supra* note 4, at 914.

substantive consolidation as the SLLC, but with higher operating costs.[159]

The series LLC is one of the newest permutations of the limited liability company business form.[160] As yet, it remains mostly untested, as it has been adopted by only fifteen states and Puerto Rico.[161] Much of the previous literature regarding series LLCs discusses the potential benefits and risks for a client to form their business as a series.[162] However, the concerns of state policymakers are vastly different from that of an individual business owner. Instead, policymakers want to ensure that, in the aggregate, they can benefit their state and local economy. This article will argue the series LLC has the potential to revolutionize small business, incentivize foreign registration in states, and promote overall economic growth.

The main attraction of the series LLC is the tax break it provides to small business. Although theoretically, a business of any size could form as a series LLC, it provides the most potential benefits to small businesses. In the aftermath of the 2008 financial crisis, small businesses were increasingly pushed out of the market, crippled by debt.[163] Essentially, a series LLC allows a parent company to file one form with the Secretary of State and then create smaller, separate "series" companies without additional filings (and filing fees) with the state.

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159 Larry E. Ribstein & Robert R. Keatinge, RIBSTEIN AND KEATINGE ON LIMITED LIABILITY COMPANIES §4:17 (2d ed. 2012).

160 Dominick T. Gattuso, *Series LLCS: Let's Give the Frog a Little Love*, 17 BUS. L. TODAY 33, 33 (July/Aug. 2008).

161 *See supra*, Part I, Section (A). Delaware was the first state to adopt the series LLC in 1996. The next state to adopt the form was Oklahoma, but not until 2004. After that, adoption took off rapidly, as Oklahoma was closely followed by Illinois, Nevada, and Tennessee in 2005. In 2008, Iowa became the sixth state to adopt the series LLC form, followed by Texas in 2009. Non-states have also indicated interest in series LLCs, as Puerto Rico adopted them in 2009, followed by the District of Columbia in 2011. In 2012, Kansas adopted the series form, followed by Missouri, Montana, and Utah in 2013. Alabama adopted the series LLC in 2014. Indiana is the most recent state to adopt the series LLC at the writing of this article.

162 *See* Mertens, *supra* note 4, at 311; *see also* Kray, *supra* note 4, at 547; *see also* White, *supra* note 4, at 28.

163 Arthur B., Kennickell, Myron L. Kwast & Jonathan Pogach, SMALL BUSINESSES AND SMALL BUSINESS FINANCE DURING THE FINANCIAL CRISIS AND THE GREAT RECESSION: NEW EVIDENCE FROM THE SURVEY OF CONSUMER FINANCES, FINANCE AND ECONOMICS DISCUSSION SERIES 2015-039, WASHINGTON: BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM (2015), *available at* https://perma.cc/GYY3-VTDH.

Depending on the state's fee structure, this could mean thousands of dollars in savings for any individual business owner who currently operates multiples LLCs. In the aggregate, this is potentially tens of millions of dollars in state filing fees.

The SLLC not only saves money, but also lowers administrative costs by decreasing bureaucratic red tape. Further, the SLLC offers the same benefits of diversification of risk as operating multiple single-member LLCs. Rather than having to invest in a business as a whole, an investor can select one specific series, choosing perhaps a higher or lower risk option.

i. Free-Market Economic Schools of Thought: Austria and Chicago

The free-market benefits of individual action and reduced government interference are the most obvious benefits of the adoption of the series LLC. Most pertinent to the discussion here is the Austrian view of the intersection between social institutions, law, and market decisions.[164] In Friedrich Hayek's *The Constitution of Liberty*, he asserts that laws made by social institutions (like governments) should be constructed to allow "maximum freedom to the individual who uses the law as part of his knowledge base in his or her decision concerning what action to take."[165] To this end, Austrians propose that individuals act *entrepreneurially* rather than based on an abstract calculation of *utility*.[166]

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[164] The Austrian School of Economics is an approach to economic theory in stark contrast to the typical neoclassical way of thinking. Instead of focusing on *utility*, *rational actors*, and *mathematical equations* in an aggregated, general sense, the Austrian school focuses on the individual actor's economic decision in the face of uncertainty and imperfect knowledge. *See* John M. Czarnetzky, *Time, Uncertainty, & the Law of Corporate Reorganizations*, 67 FORDHAM L. REV. 2939, 2957 (1999).

[165] Linda A. Schwartzstein, *An Austrian Economic View of the Legal Process*, 55 OHIO ST. L.J. 1049, 1064 (1994) (citing FRIEDRICH A. HAYEK, THE CONSTITUTION OF LIBERTY 35 (1960)).

[166] Ludwig von Mises, one of the fathers of Austrian economic theory, approached economics as a study of subjective human action. He defined "entrepreneur" as an "acting [person] exclusively seen from the aspect of the uncertainty inherent in every action. In using the term, one must never forget that every action is imbedded in the flux of time and therefore involves a speculation. . . . There's many a slip 'twixt cup and lip." LUDWIG VON MISES, HUMAN ACTION: A TREATISE ON ECONOMICS (1949) at 254. *See also* John M. Czarnetzky, *Time, Uncertainty, & the Law of Corporate Reorganizations*, 67

Rather than treating time as an allocable resource per the neoclassical view, Austrians view time as *dynamic*, something that acts on an individual from one moment to the next as that individual makes subjective decisions and acquires greater information with which to make future decisions.[167]

Over time, these subjective decisions yield (albeit imperfect) knowledge, decreasing mutual ignorance across social interactions.[168] "[T]he market process provides the context and incentive for entrepreneurs to perceive and exploit opportunities in the form of market gaps or disequilibrium."[169] Professor David Harper proposed the "growth of knowledge" model of entrepreneurship,[170] positing that individuals constantly formulate hypotheses to solve problems encountered in the market, and so are constantly engaging in a learning curve of trial and error.[171]

Now to return to the "intersection" mentioned at the beginning of the subsection. The series LLC offers greater freedom for business owners to make decisions, per Hayek's notion that laws should maximize individual freedom of choice.[172] Individual entrepreneurs in the market are the best suited to acquire knowledge through trial and error in social or market interactions.[173] And social institutions, like the government, should encourage entrepreneurs to make decisions to increase overall human knowledge and incentivize growth.[174] Or, put more succinctly by Milton Friedman, "Governments never learn. People learn."

Milton Friedman was the founder of the Chicago School of Economic Thought, somewhat related to the Austrian School as both are "methodological individualists."[175] Although they differ wildly on the proper approach to economics, and methodology thereof, the ultimate

FORDHAM L. REV. 2939, 2957 (1999).

167 *See* GERALD P. O'DRISCOLL, JR. & MARIO J. RIZZO, THE ECONOMICS OF TIME AND IGNORANCE 52-70 (1985).

168 Professor Israel Kirzner first posited this theory of markets in the Austrian school. *See* ISRAEL M. KIRZNER, COMPETITION AND ENTREPRENEURSHIP (1973).

169 Czarnetzky, *supra* note 164 at 2958-59.

170 DAVID A. HARPER, ENTREPRENEURSHIP AND THE MARKET PROCESS: AN ENQUIRY INTO THE GROWTH OF KNOWLEDGE at 5 (1996).

171 *Id.* at 121.

172 Hayek, *supra* note 165.

173 Hayek, *supra* note 165.

174 Czarnetzky, *supra* note 164 at 2959.

175 *See* Karl-Heinz Paqué, *How Far is Vienna from Chicago? An Essay on the Methodology of Two Schools of Dogmatic Liberalism.* 38 KYKLOS 412 (1985).

policy prescriptions made by both are solidly "free-market."[176] In his seminal work, *Capitalism and Freedom*, Friedman carefully explains that government serves two important twin interests in the market: to create a forum "'rules of the game'" and to then enforce those rules. [177] "What the market does is to reduce greatly the range of issues that must be decided through political means, and thereby to minimize the extent to which government need participate directly in the game."[178] He proposes that free markets are what allow for division of labor, specialization, and diversification of thought and action.[179] He famously once said he was "in favor of cutting taxes under any circumstanc[e] and for any excuse, and for any reason, whenever it [was] possible."[180]

The notion of complex fiscal policy is far outside the scope of this article, but Friedman's words are nevertheless relevant here. Annual filing fees are, in the simplest sense, still an annual tax on the business. The series LLC form helps businesses by creating annual savings, which in turn adds to the overall wealth of the marketplace and allows for greater creativity and business growth, which helps investors achieve greater returns on investment. The series LLC form offers significant opportunity to diversify risk.[181] For business owners, this means isolation of a riskier business venture in one distinct series, minimizing the risk of contagion to other healthier, lower-risk series. Businesses can make higher risk decisions, and allow for greater market creativity. And, if the series LLC statute is structured properly, creditors will be on notice that they have invested in an individual series. Risk-averse creditors can select individual lower-risk series, rather than investing in a business as a whole.

It is important to balance the seemingly competing interests of pro-business factions with the legitimate concerns of pro-creditor, pro-plaintiff protection. There is concern that series LLCs create more risk for investors because they might be unaware of the limitations of investing in a series, or that a series can be used for nefarious

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[176] Robert P. Murphy, *The Chicago School versus the Austrian School*, *available at* https://perma.cc/EXN7-NV56.
[177] MILTON FRIEDMAN & ROSE FRIEDMAN, CAPITALISM AND FREEDOM 15 (1982) ("These then are the basic roles of government in a free society: to provide a means whereby we can modify the rules, to mediate differences among us on the meaning of the rules, and to enforce compliance with the rules on the part of those few who would otherwise not play the game.").
[178] *Id.*
[179] *Id.*
[180] *See* Becker Friedman Institute, *available at* https://perma.cc/B8H9-8P8B.
[181] Fezzi, *supra* note 4, at 914.

purposes.[182] These concerns are systemic to all business forms to some extent, but the insular nature of the series may exacerbate these fears.

Ultimately, however, these two "competing" interests work together. Businesses have an inherent incentive to act in a way that promotes investment and protects creditors. Without creditors, most businesses could never get off the ground. Without investment, the economy would shrink measurably. If a business looks too risky, or has mistreated creditors in the past, why would any creditor ever invest in it again? If a business is acting rationally, they will act in a way that protects their creditors and increases the likelihood they will receive future investment.

ii. Short-Term Annual Filing Revenue Loss is Outweighed by Long-Term Growth Gains

Policymakers may be wary to select legislation that, on its face, seems to reduce the overall state tax revenue. But this inquiry leaves out the balancing of the short-term pain of revenue loss with the long-term gains from a larger, more productive tax base. It is easy to look at a state's budget for a given year and say the loss of revenue cannot be absorbed, or the money generated by annual business filings is designated for some specific purpose.[183] The United States economy as a whole is still feeling the effects of the 2008 economic downturn, and it may be better for the long-term health of state economies to innovate, incentivize growth, and promote the formation of new business.[184]

One of the best ways to encourage this kind of long-term health is to help business owners save money on annual taxes. That aggregated tens of millions of dollars in savings will remain in the pocket of small business owners who can then redistribute that money throughout the state and local economy, diversifying business, creating competition, and promoting investment. The short-term pain felt by states in losing state filing fees should be exactly that: short-term. Because if the economy within the state grows as a result of business savings, the tax base within the state will grow and ultimately the state will reap those rewards. In sum, although states may experience a short-term loss in revenue, the

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[182] *Id.*
[183] For example, in Mississippi the money generated from foreign LLC filings is used to fund all elections within the state. *See* MISS. CODE ANN. § 23-15-5 (2016).
[184] *See* Ben Leubsdorf, *The Recession's Economic Trauma Has Left Enduring Scars*, WALL ST. J. (May 9, 2016), https://perma.cc/6W3A-9Z92.

benefits of a larger and increasingly productive tax base should eventually supplant that loss by increasing the overall wealth of the state.

The series LLC form is optimal for business owners operating multiple businesses. The benefits and structure of the series are most obvious in a real estate or investment context. The SLLC's ramifications for small business have repeatedly been overlooked, for occasionally paternalistic reasons. The ULC first refused to include series LLC provisions in RULLCA because they were concerned citizens would not understand how to use the entity.[185] Several states have refused adoption for similar reasons. However, publicizing information on appropriate state websites, and ensuring information about SLLCs in their state is readily available, should alleviate concerns over potential confusion. It is also somewhat paternalistic to assume that the series form can only be used in "sophisticated" business states like Delaware.[186] This assumes no creativity in the market.

Importantly, though, this means the series LLC form is not right for every business. A person who owns and operates only one business, with no immediate plans to expand, should not form as a series LLC. Although the state will be losing some annual revenue from business filing fees, that money will not completely dry up because not everyone will choose the series LLC form. This means the state will still receive considerable income each year from state business filings. But for those business owners operating multiple LLCs in the same state, the state is not "double-dipping" and collecting from the same entrepreneur multiple times over.

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[185] *See* Mertens, *supra* note 4, at 304-06.

[186] Daniel S. Kleinberger, *Progress Report on the Revised Uniform Limited Liability Company Act ("ULLCA") and the Issue of "Corpfuscation,"* Vol. XXIII A.B.A. THE SEC. OF BUS. L. PROGRAM, Mar. 2006 at 7, 8-9 (citations omitted) ("Originally devised by sophisticated Delaware lawyers for their 'funds' clients, series are now being (mis)used to subdivide assets of operating businesses and to provide unwarranted hopes of low cost 'asset protection'. . . . [w]hat's good for Delaware and highly sophisticated business deals is not necessarily good for the LLC law of other states. A philosophy that works wonders for 'high end' transactions may be bad medicine for thousands of more prosaic but nonetheless important closely held businesses that choose to house themselves within LLCs."); *See also* Fezzi, *supra* note 4, at 917-18 ("Clearly, the ULC was taking a patriarchal stance for states other than Delaware. Besides the ULC Drafting Committee, many commentators were worried about non-Delaware practitioners misunderstanding the formalities of the series LLC, and thus opening themselves up to liability.").

Finally, States should consider the adoption of the series LLC in the context of their existing business entity law.[187] For example, states that have already adopted the Revised Uniform Limited Liability Company Act, or the Model Business Corporation Act, may find it fairly simple to adopt most of the language of the upcoming Limited Liability Company Protected Series Act (July 2016 Annual Meeting Draft).[188] For states that already recognize "series" under their laws as classes of stock or membership interests, it may require slightly more drafting to make sure those code provisions remain explicitly distinguishable.[189]

B. Statutory Construction Should Include Equity Factors from Substantive Consolidation to Minimize Risk of Asset Collapse

Equity factors from substantive consolidation should be included in the statutory language as an inverse. For example, a judge will look to see if two businesses operate under the same bank account, and if they do, that will weigh in favor of consolidating the two businesses as one asset pool. However, if a policymaker includes a requirement in the statute that businesses operate separate bank accounts, this will mitigate the likelihood of consolidation later by forcing business owners to comply during formation.

i. The July 2016 Annual Meeting Draft Offers Improvement, But Left Substantive Consolidation Potential Mostly Unmitigated

In July of 2017, the National Conference of Commissioners on Uniform State Laws (NCCUSL) is expected to release the final version of the Limited Liability Company Protected Series Act (July 2016 Annual Meeting Draft).[190] The NCCUSL has made several strategic choices to improve the marketability of the series LLC to state legislatures. First, they designated "series" as "protected series,"

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[187] *See supra,* Part I, Section (B)(iii). The July 2016 Annual Meeting Draft is purposefully structured to complement existing limited liability company to maximize understanding and ease of cross-referencing.
[188] *See supra* Part III, Section 1.
[189] Minnesota is a good example. *See* MINN. STAT. § 302A.137 (2016).
[190] Introduction to 2016 Annual Meeting Reading of the Limited Liability Company Protected Series Act (f/k/a Series of Unincorporated Business Entities Act), *available at* https://perma.cc/SZY9-KZJS.

adopting a term of art to separate the general terminology of "series" from the traditional usage in classes of stock.[191] The Uniform Act incorporates much of the innovative language from the Illinois statute, with a few additions: series LLCs would create "protected series" which must include the name designation of "P.S.," the series LLC must file annually with the Secretary of State, and include a list of all the protected series under its umbrella, in order to obtain a "certificate of good standing" from the Secretary of State to provide to any potential investor or creditor.[192] The July 2016 Annual Meeting Draft contains clear, concrete language creating two types of liability shields: vertical (traditional parent-to-subsidiary), and horizontal (brother-to-sister).[193] Clearly, protected series are liable for their debts and obligations, and investors should be on notice as such.

Interestingly, the July 2016 Annual Meeting Draft continues the position that a protected series is not subject to merger or acquisition, despite asserting "[a] series is . . . a person."[194] The July 2016 Annual Meeting Draft also continues the practice from Delaware of not requiring a protected series to establish an operating agreement, only requiring the parent series LLC to do so.[195] Although the July 2016 Annual Meeting Draft kept some of the language of "certificate of designation" from the Illinois statute, they left out important language pertaining to what the certificate contains. The Illinois statute requires a certificate of designation be filed for the creation of each series, containing the names of the members or managers of that series, to be on file with the Secretary of State's office for creditor-notice purposes.[196] The July 2016 Annual Meeting Draft requires the operating agreement to contain the names of the protected series and any managers or members.[197] No state currently requires an LLC to file their operating agreement with the Secretary of State, so how could creditors obtain the names of managers or members if those names are not listed on a certificate of designation? The July 2016 Annual Meeting Draft does encourage transparency by making public the identity of the series, and whether a given business is a

[191] Ltd. Liab. Co. Protected Series Act (July 2016 Annual Meeting Draft) *supra* note 1.
[192] *Id.* at §§ 201- 202, § 205.
[193] *Id.* at § 401.
[194] *Id.* at § 102(7).
[195] *Id.* at § 107.
[196] 805 ILCS 180/37-40(d).
[197] Ltd. Liab. Co. Protected Series Act (July 2016 Annual Meeting Draft) *supra* note 1, at § 302(b).

protected series.[198] But it does not make public the names of members or managers of any protected series, by including those requirements only in the operating agreement.

This language removes some of the uncertainty regarding judicial treatment and rights of series LLCs, but it may be prudent to go a step further and include as many factors borrowed from substantive consolidation doctrine as possible. In substantive consolidation, the legal relationship between the two entities is much more important than the business form.[199] For example, it might be more indicative of the series' independence if it were allowed to merge with other series or businesses. The July 2016 Annual Meeting Draft requires that all associated members of a protected series also be members of the series LLC parent.[200] The Act does not clarify why it made this decision, but it might make substantive consolidation more likely because courts are often looking at the overlap in management or ownership between business entities. Instead, the Act might require that each series have an unaffiliated member, for the purposes of maintaining separate entity status.

ii. Risks and Rewards for Both Businesses and Creditors

Substantive consolidation may, unwittingly, prioritize the recovery of less risk-averse investors. For example, if Series X carries riskier assets than Series Y and Z, and the investors in Series X are sure that a bankruptcy court will substantively consolidate all series should Series X become insolvent, they are safe in assuming their investment can be recouped against Series Y and Z. However, this punishes the investors of Series Y and Z who may have purposefully selected a less-risky asset for their portfolio by raising the endemic risk across all the series X, Y, and Z. In fact, it removes a lot of the appeal of the series LLC, namely that investors can diversify their portfolios based on risk-assessments, without the concerns of investing in a whole business.[201]

By including notice provisions in the series LLC statute, creditors can make a better-informed investment decision.[202] This

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[198] *Supra* note 1, § 202.
[199] 2-105 COLLIER'S ON BANKRUPTCY ¶ 105.09.
[200] *Supra*, note 1, § 302.
[201] *See* Christopher S. McLoon & Margaret C. Callaghan, *The Dangerous Charm of the Series LLC*, 24 ME. B.J. 226, 227 (2009).
[202] *See* Fink, *supra* note 7, at 613 ("Creditors know to check filings to see if an entity has limited liability.").

provision also protects businesses, because creditors should be on notice that they have invested in a series and not a whole business.[203] And it also protects creditors, who can select more or less-risky series for their portfolio.[204]

The series LLC form may encourage business owners to put their more creative (but risky) business ideas into action but with far less risk. If a business owner is concerned that a riskier business idea might cause contagion to the rest of the business' assets should it go under, they are probably unlikely to put that idea into action. However, by removing that riskier asset to a protected series, a business owner can limit the risk to other less-risky protected series within the SLLC.[205] This promotes creativity in the market, and the potential for greater growth.

V. Bankruptcy Courts Should Adopt a Rebuttable Presumption that Protected Series are Separate and Distinct Entities to Balance Pro-Creditor/Pro-Business Interests

If a business is properly incorporated a series LLC, then a bankruptcy judge should find a rebuttable presumption that a series is a separate and distinct entity.[206] There are indications that a series would be considered distinct in its own right, because the IRS has issued an opinion letter saying series would be separate for tax purposes.[207] Although it has never been directly litigated or stated, literature suggests that an individual series meets the qualifications of a "person" under the bankruptcy code.[208] For bankruptcy "personhood," a business needs to have the "rights and powers" of a corporation.[209] It is now widely accepted that an LLC qualifies as a person under the Code, and it is likely with time and increased litigation, the series form would also qualify.[210]

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203 *Id.*
204 Fezzi, *supra* note 4, at 913 ("Rather than invest in a single, which many contain both conservative and riskier assets, the series LLC structure allows investors to choose which assets to place in their portfolio.").
205 *Id.*
206 *See* Bahena, supra note 26, at 815.
207 I.R.S. Gen. Couns. Mem. 39,211 (Jan. 13, 1984).
208 *See supra*, Part II (A).
209 *See supra,* note 94.
210 *See supra,* note 97.

But, no bankruptcy court, or other court, has taken up the issue. The only cases examining a series LLC are *Alphonse* and *GxG Management*, neither of which held anything related to series LLCs; both cases mention series LLC in dicta, claiming they are mostly notable for the unanswered questions they present. Ultimately, if the series LLC form was created for its dual internal liability shields, it would render the series LLC a pointless theoretical exercise if, in practice, courts are regularly finding all series LLCs to be one larger business form ripe for consolidation or veil-piercing.

A. If Not a Rebuttable Presumption, Then What? (A Theoretical Exercise)

i. Always Separate (Never Consolidate)

Courts could decide that series LLCs are always separate entities, and never consolidate or pierce the veil. This argument is theoretical *ad absurdum,* as no court is going to de facto always decide one way. But for the argument's sake, this provides some clarity. Although this is the very purpose of the series LLC form, to insulate assets and risk from one another, this does not fairly balance pro-creditor interests. Creditors would nearly always be left without a way to recoup their losses if an individual series LLC became insolvent. And finally, series LLCs could become the safe harbor of murky investments and dark money that many fear that they are. To always treat series LLC as separate may open the door to anti-creditor action on behalf of businesses who feel they have nothing to lose by engaging in such behavior.

ii. Always One Entity (Always Consolidate)

Courts could also treat series LLCs as always one business, a position bolstered in states like Texas that specifically state series LLCs are not a separate, domestic entity under state law.[211] This complicates the bankruptcy ramifications of a series, because often-state corporate law is being applied in substantive consolidation proceedings. Consistently treating series LLCs as one family, one business unfairly tips the scale towards creditors, as the business is never able to take full advantage of the internal liability shields typifying the series form. This

[211] See TEX. CODE ANN. §101.622.

position may also unfairly favor certain creditors over others, as the rights of riskier investors may be de facto prioritized over more risk-averse creditors who purposefully selected safer series for investment. Finally, this response by courts begs the question why even attempt to use a SLLC? If one is sure a court is never going to observe the internal liability shields typifying the structure, then what is the incentive for using it in the first place?

B. Statutory Construction Alone is too Pro-Business, Rebuttable Presumption Balances Pro-Creditor Concerns Equitably

A rebuttable presumption is the right choice for bankruptcy courts because it strikes the proper balance between protecting creditors and incentivizing business. If businesses are exercising their duty of care to ensure they are incorporated correctly and are minding all the statutory requirements of a series, then the courts will "reward" them with a rebuttable presumption of separateness. However, courts are able to "punish" series LLCs for any wrongdoing in formation, particularly those errors that negate creditor notice.[212]

Recognizing series to be separate and distinct is important for all creditors, because each series will have its own individual investors. It would be unfair to the investors of Series 2 if Series 1 declares bankruptcy, and a judge consolidates all assets to redress the creditors of Series 1. In this case, the Series 2 investors are being needlessly punished. Instead, the procedure would look just like any other corporate bankruptcy: the series becomes insolvent, the court awards its liquidated assets to creditors in hierarchical order. So, in our example, Series 1's investors could collect from the liquidated assets of this series, and the assets of Series 2 would remain completely untouched.

By adopting a rebuttable presumption of separateness, courts can respect the internal liability shields of a series, but balance creditor interests. If a series LLC fails to observe the proper corporate formalities, or incorporates/files documents incorrectly, then creditors can effectively punish a series LLC for this failure.

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[212] *Compare* Bahena, *supra* note 26, at 814.

C. Rebuttable Presumption Makes Sense in Context of Analogous Law

Series LLC should be considered separate and distinct, especially upon considering other analogous examples.

i. Consolidated Federal Tax Returns

Analogies from other areas of law, even sometimes completely unrelated law, may prove illustrative. In the case of the series LLC, an example from corporate tax law may be instructive, namely consolidated returns. Generally, corporations report their annual income, make deductions, and file this paperwork with the Internal Revenue Service separately from one another. However, for those taxpayers owning or operating multiple businesses ("affiliated corporations"), this annual filing can be expensive and tedious. Provisions allowing for consolidated returns instead permit affiliated corporations to file one consolidated return as if they were one single corporation, provided they all share a common parent corporation.[213] However, even though the federal tax liability of affiliated groups of corporations is based on the combined taxable income of its members, "the separate tax identity of each member of the group is respected through maintenance of individual earnings and profits accounts."[214]

Although this area of tax law has been in a state of flux, recent trends in regulation indicate *single entity* status; that the several member-corporations of the affiliated group are treated in the same manner as divisions of a single corporation.[215]

Here we have a group of affiliated corporations with overlapping shareholders, consolidating their federal tax documents as a *single entity*

[213] PAUL R. MCDANIEL et al., FEDERAL INCOME TAX OF BUSINESS ORGANIZATIONS 823 (David L. Shapiro et al. eds., 2nd ed. 1997) ("An affiliated group consists of the common parent and one or more chains of corporations connected through stock ownership with the common parent. I.R.C. §1504(a)(1). The common parent must own stock of at least one other corporation that represents at least 80 percent of the total voting power of the stock and has value equal to at least 80 percent of the total value of the stock of the corporation. . . . . Thus, a single chain of connected corporations or parallel brother-sister corporations connected to a common parent corporation can qualify as an affiliated group.").
[214] Treas. Reg. §§ 1.1502-14, -19, -31, -32, and -33.
[215] MCDANIEL, *supra* note 213, at 819-23.

for ease, convenience, lower cost, and less red tape. The parallel to the series LLC is unmistakable: a group of affiliated protected series, and their common parent, are filing one annual Secretary of State report as if they were one limited liability company in their state of formation because it is convenient, more cost-effective, and decreases potential regulatory pitfalls. The series LLC is the functional equivalent of the federal consolidated tax return, but for state filing at the state level.

In the earlier discussion of "alter ego" doctrine in the bankruptcy context,[216] there is a list of several elements and factors used by courts in its determination. Here, it is important to distinguish that *alter ego* theory is relevant to both bankruptcy and corporate veil piercing (a variant of fraud doctrine).[217] To give the briefest of explanations for clarity's sake, corporate veil piercing is the disregarding of the corporate form by a court to make a plaintiff whole for fraud or misrepresentation by the corporation.[218] This doctrine employs many of the same elements and factors as substantive consolidation doctrine; courts are looking for many of the same actions by corporations.

One miscellaneous factor occasionally raised by plaintiffs in corporate veil piercing suits is consolidated financial filings or tax returns.[219] However, courts have generally held these statements insufficient: a parent corporation's "decision to include [its subsidiary] in its consolidated tax return hardly demonstrates domination."[220] Meaning, consolidated tax returns cannot serve as a sufficient basis for imposing liability under an alter ego theory.[221] "[C]onsolidating the activities of a subsidiary into the parent's annual reports is a common business practice . . . allowed by both the Internal Revenue Service and the Securities and Exchange Commission, and it is recommended by generally accepted accounting principles."[222]

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[216] *See* Gilbert, *supra* note 131, at 211.

[217] Outokumpu Eng'g Enters. v. Kvaerner Enviropower, 685 A.2d 724, 729 (Del. Super. Ct. 1996) (noting alter ego theory and veil piercing are "analogous").

[218] Douglas G. Smith, *Piercing the Corporate Veil in Regulated Industries*, BYU L. Rev. 1165, 1180 (2008).

[219] *Id.* at 1178.

[220] AT&T Co. v. Compagnie Bruxelles Lambert, 94 F.3d 586, 591 (9th Cir. 1996).

[221] Lowell Staats Min. Co. v. Pioneer Uravan, Inc., 878 F.2d 1259, 1264 (10th Cir. 1989).

[222] Calvert v. Huckins, 875 F. Supp. 674, 678-79 (E.D. Cal. 1995); *see also* Dalton v. R & W Marine, Inc., 897 F.2d 1359, 1363 (5th Cir. 1990) (holding no alter ego liability despite filing a consolidated tax return, among other factors,

Courts have examined consolidated federal tax returns in the veil-piercing context and considered them not to be indicative of either an alter ego relationship or a factual unitary whole of the affiliated organizations. Following this line of thinking through to series LLCs, the fact that series file one consolidated annual state report should not impact their status as separate and distinct entities. Theoretically, a federal tax return should be strong evidence to disregard the corporate fiction because the federal government—a preemptive body—is treating a business as one. But if such a preemptive body as a federal agency is treating state-formed entities as functionally separate, but-for ease of annual filing purposes, this is strong evidence to support the rebuttable presumption of separateness of series LLCs in a substantive consolidation bankruptcy case.

ii. Corporate Structure Analogy: Hedge Funds

Hedge funds are structured analogously to series LLCs, which may help illustrate bankruptcy treatment. Hedge funds are generally formed as individual limited partnerships or limited liability partnerships, usually operating within the greater structure of a bank or investment portfolio (sometimes a fund of funds).[223] This individual LP may co-exist with a large number of other LPs, within the same umbrella organization. There is typically one general partner, usually a corporation or an individual (possibly the manager of the fund).[224] And then, the limited partners are typically the individual investors of that fund.[225] Series LLCs are not quite the same, but they have enough similarities that this analogy is instructive.

We do not really think of "hedge funds" as declaring bankruptcy, although they certainly can.[226] More often, colloquially, we say that if a

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for affiliated corporations); O'Berry v. McDermott, Inc., 712 S.W.2d 206, 207 (Tex. App. 1986) (holding that, among other factors, filing a consolidated tax return was insufficient to support alter ego theory).

[223] Joseph G. Nichols, *Hedge Fund of Funds Investing: An Investor's Guide*, BLOOMBERG PRESS at 16-17, 51 (2004).

[224] *Id*. at 16. ("The general partner can be an individual or a corporation and is responsible for the management and operation of the partnership and has unlimited liability. The manager will typically be the general partner but act through an entity to avoid unlimited personal liability for fund obligations.").

[225] *Id.*

[226] *See* S. Ari Mushell, *Feature, Dodd-Frank and Hedge Funds: An Uneasy Fit?,* 32-6 ABIJ 38 (July 2013).

hedge fund goes under, the individual limited partnership itself holding the investment asset liquidates. It sells off all assets and pays out investors to the fullest extent possible. It would be unusual for the operating bank or investment company, even if they were the general partner to the partnership, to declare bankruptcy or go out of business if just one hedge fund within its greater portfolio of investments closes. To summarize, and prevent unnecessarily arcane details, the recent sub-prime mortgage crisis is a good example. In July of 2007 two of Bear Stearns' flagship hedge funds closed, however Bear Stearns did not itself declare bankruptcy.[227]

Series LLCs operate in a similar way: if an individual series declares bankruptcy, that one series liquidates, pays off its creditors, and closes.[228] The parent series LLC, and the other series within that parent, do not also (necessarily) declare bankruptcy or close.

VI. Application

This section explores the plight of a fictional business owner, named Stephen Serial. In subsection A, his state, State X, has adopted the statutory construction of the SLLC form advocated in Part IV *supra*, and he has elected to form a series LLC. Unfortunately, in subsection B, one of his protected series declares bankruptcy and he finds himself in federal bankruptcy court. Here we discuss how the legal mechanism of a rebuttable presumption for separateness might really look in practice.

A. Statutory Construction

State X has decided to adopt the series LLC. It has previously adopted the Revised Uniform Limited Liability Company Act, and chose to adopt the close variant of the Model Act advocated here. To summarize, the law designates series LLCs as having "protected series." Protected series are considered "persons" under the law, and can sue and be sued in their own name, and own property, just as any other limited liability company. The law requires separate bookkeeping between protected series, and prohibits commingling of funds. Protected series must file a certificate of designation with the Secretary of State's office

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[227] Fin. Crisis Inquiry Comm'n, *The Financial Crisis Inquiry Report: Final Report of The National Commission on the Causes of the Financial and Economic Crisis in the United States*, 240 (2011).
[228] *See* Ltd. Liab. Co. Protected Series Act (July 2016 Annual Meeting Draft), *supra* note 1.

per the Model Act, but rather than requiring the members and managers only be listed in the operating agreement, they must *also* be listed on the certificate of designation for their respective protected series. Additionally, each protected series must have at least one member or manager unaffiliated with the parent series. Merger and acquisition is permitted for a protected series. Finally, protected series are allowed to consolidate for tax filing purposes, contract jointly, and work cooperatively with another if they so choose.

Steven Serial owns ten rental properties, currently as multiple LLCs. State X requires a $500 annual filing fee per LLC.[229] This means he's currently paying $5,000 in annual state filing fees alone, not including the costs of hiring an accountant and lawyer to put together all the proper documentation for each respective LLC. He wants to convert his ten limited liability companies into one SLLC now that State X has adopted the form. He knows this will save him thousands of dollars each year, and give him greater flexibility in management. He plans to use the saved annual revenue to add more rental properties to his portfolio, and grow his business.

He has complied, to the best of his knowledge, with all the statutory provisions set forth in the statute. His formation documents filed with the Secretary of State's office include that his business is an SLLC with the right to create protected series, named "Serial Rental Properties, SLLC." Each of his ten rental properties have been renamed to a variation of "Serial Rental Properties, Series ___, P.S." He maintains separate bank accounts, accounting books, and records for each of his 10 rental properties. He has recruited 10 different individuals to serve as members or managers of each protected series, whose names appear on the appropriate certificates of designation filed with the Secretary of State's office.

B. Rebuttable Presumption

Unfortunately for Stephen Serial, the rental property owned by Series J has a disastrous mold problem all throughout the walls of the structure. It has been unwittingly causing the tenant, Mindy Moulder, horrible health problems ever since she moved in. She files suit against Protected Series J to recover for the cost of her medical expenses, breach of the implied warranty of habitability, and emotional distress caused by

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[229] *See* MASS. GEN. LAWS ch. 156(c) §12(d) (designed to mimic a real-life situation, I have chosen to use Massachusetts as a reference, as it requires a $500 annual filing fee for domestic LLCs).

the systemic, long-term illness she has now developed. In paying the settlement of the lawsuit, Protected Series J becomes insolvent and declares bankruptcy. Steven Serial had brought in several investors for his various protected series, to increase the capital structure of his business. One of the investors in Series J is Irving Investment.

At the bankruptcy proceeding, Irving tries to claim several things in an effort to recover as much as possible of his investment. He claims that: Series J is just an alter ego of "Serial Rental Properties, SLLC" and Protected Series A-I; he did not receive adequate notice that he had only invested in Series J and did not know that the assets of the rest of the protected series would not be available for recovery. Irving stipulates that substantive consolidation is an appropriate remedy. Judge Jules determines there is a rebuttable presumption that protected series are considered separate and distinct under the law, and asks if Irving has enough evidence to rebut the presumption and substantively consolidate.

Irving provides evidence that Protected Series J is financed by Serial Rental Properties, SLLC and provides monthly cash infusions to its accounts from the parent SLLC's master account. Further, Serial Rental pays all the staff and employees affiliated with Series J (the cleaning service for the rental property, the agent that manages the accounts and shows the property to prospective renters, etc.). Serial Rental Properties, SLLC points to evidence that Irving knew, or should have known, he was investing in *only* Series J because the business complied with notice provisions under the statute. Meaning, Irving never relied on the credit of the entire SLLC, but rather only of Series J.

Judge Jules weighs the evidence provided by Irving Investment against the rebuttable presumption of separateness to determine if there is a "substantial identity between" Serial Rental and Series J. Then, he considers if consolidation is necessary to either (1) prevent harm to Irving Investment, or (2) confer a benefit to him or other investors. Finally, Judge Jules must consider whether the evidence of wrongdoing provided by Irving "far outweighs" the considerable prejudice to the creditors of Protected Series A-I.

If Judge Jules finds there is insufficient evidence in the record to indicate wrongdoing on the part of Stephen Serial/Serial Rental and Protected Series J, then Irving Investment will likely lose his claim to substantive consolidation. Meaning, his recovery will be limited to the liquidated assets of Protected Series J, his original investment vehicle. However, if Judge Jules is persuaded that Irving has raised several violations serious enough to warrant "punishment" of Serial Rental and Protected Series J, he may order substantive consolidation. However, a few small potential violations may not be enough to persuade a bankruptcy judge to exercise their power to substantively consolidate.

Now, using the same facts as above, imagine that Irving Investment also provides further evidence of potential wrongdoing: (1) that Series J has only one asset, the rental property previously rented by Ms. Moulder, conveyed to them by the parent, Serial Rental (i.e. it was not purchased by Series J in its own right). And, (2) Irving shows evidence that demonstrates the 3 members or managers of Series J do not act in its best interest, but rather take direction from Stephen Serial/Serial Rental at monthly director's meetings and simply follow instructions. Given these additional potential issues, Judge Jules may find there is enough in the record to overcome the presumption of separateness and substantively consolidate Protected Series J with Serial Rental Properties, SLLC to make Irving whole. This determination of the rebuttable presumption of separateness will ultimately turn on the individual judge hearing the case. Generally, it is agreed upon that substantive consolidation is a power to be exercised sparingly, but some judges may be more willing than others to overcome that presumption (as indeed, they may be more willing to overcome the presumption of separateness for an SLLC).

VII. CONCLUSION

The series LLC offers policymakers a low-cost way to promote economic efficiency and new business formation in their state. Post-2008 economic recovery has been slow;[230] states are concerned about the stability of their economies. With the anticipated 2017 release of the Uniform Law Commission's Series LLC Model Act,[231] there has never been a better time to consider the many potential benefits of adopting the series LLC.

Adopting the series will help to promote economic growth, decrease red tape, and maintain a balance between pro-creditor and pro-business interests. Wealth generated by a healthy business sector provides the tax-base to support the important social welfare programs we have come to depend on like Medicare, Medicaid, Social Security, and Unemployment Insurance. Balancing pro-business interests with pro-creditor is of the utmost importance when structuring economic policies.

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[230] Eric Morath, *Seven Years Later Recovery Remains the Weakest of the Post-World War II Era*, WALL ST. J: REAL TIME ECONOMICS (July 29, 2016, 10:39 AM), *available at* https://perma.cc/2KXW-V4K3.
[231] *See supra* note 1.

However, the series LLC purports to balance these seemingly competitive interests by incentivizing individual series to protect their creditors by including the maximum number of equity factors from substantive consolidation doctrine in bankruptcy. In this way, protected series are incentivized to act with maximum transparency.

A rebuttable presumption of "separateness" for each series LLC offers the best opportunity to balance pro-creditor interests by providing a solution to the uncertainty: if a series observed corporate formalities throughout formation, annual filing, and bookkeeping, and is generally not misusing the corporate form, it will be rewarded with the rebuttable presumption of "separateness." This allows creditors to recover only from the individual protected series in which they invested, or to punish the whole series LLC for wrongdoing in formation.

In sum, the series LLC offers an innovative option for state policymakers looking for ways to stimulate their local economies. With its implications for small business owners, it may even incentivize greater business formation in the long run as more individuals are exposed to the benefits of the entity form. So far, uncertainty in bankruptcy has hindered adoption by states, but with the mechanism of a rebuttable presumption much of that uncertainty is alleviated.