

BUSINESS ALERT

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THE DELAWARE SERIES LLC

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Effective August 1, 1996, Delaware amended its Limited Liability Company Act (6 Del C §§18-101—18-1109) to permit the designation of “series” of ownership interests. Section 18-215(a) of the Delaware LLC Act (6 Del C §18-215(a)) states:

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

The uniqueness of the Delaware “series” structure is that the owners of an LLC can hold separate property interests in separate series of an LLC that are *compartmentalized for liability purposes*. The profits and losses and liabilities of each series are legally separated from the other series.

Section 18-215(b) of the Delaware Limited Liability Company Act (6 Del C §18-215(b)) allows for limitation on liabilities with respect to each series of interests by providing that (1) debts, liabilities, and obligations with respect to a particular series shall be enforceable against the assets of such series only, and not against the assets of the LLC generally or any other series thereof, and (2) none of the debts, liabilities, and obligations with respect to the LLC generally or of any other series shall be enforceable against the assets of such series.

The Delaware Series LLC offers many benefits over the traditional LLC, insofar as it: (1) can be used in lieu of forming multiple LLCs or subsidiaries; (2) provides superior asset protection by segregating liabilities; (3) can reduce legal, accounting, and administrative costs and taxes; (4) facilitates more flexible equity compensation arrangements; and (5) allows tax-free transfers within the LLC.

Another advantage to forming a Delaware Series LLC is the ease of adding an additional series to the LLC or dissolving an existing series. Under 6 Del C §18-801(a), a series in an LLC is dissolved on (1) a specified date within the LLC agreement, (2) the happening of a certain event specified in the LLC agreement, (3) the affirmative vote or written consent of the LLC members associated with the series who own two-thirds in interest, or (4) judicial decree. Section 18-216(j) of the Delaware LLC Act (6 Del C §18-215(j)) states that the dissolution of a series will not require the dissolution of the entire LLC. Accordingly, the Delaware Series LLC spares its owners the time and expense of dissolving the entire LLC on sale, exchange, or other disposition of an asset held in one series. As in the case of adding a series, the unneeded series can be dissolved by a simple addendum to the LLC agreement; no instrument need be filed with the Delaware Secretary of State.

There are certain disadvantages that must be addressed. The first is that the LLC Series form has not yet been challenged in a Delaware court, so it is unclear what the result would be of litigation.

The Series should be respected as a single entity for tax purposes, although I have not found an IRS ruling on this issue. Another issue is whether the operation of an entity in one state will subject the entire Series to tax liability. Some commentators have analyzed the issue as to whether there is separate or unity tax treatment based on a case-by-case basis which is beyond the scope of this summary.

A limited liability company protects its owners from being held personally responsible for the company's debts and liabilities; the most an investor can lose is the amount that he or she invested in the company. Compare California Corp C §17101(a) with 6 Del C §18-303(a), which states:

Except as otherwise provided by this chapter, the debts, obligations and liabilities of a limited liability company, whether arising in contract, tort or otherwise, shall be solely the debts, obligations and liabilities of the limited liability company, and no member or manager of a limited liability company shall be obligated personally for any such debt, obligation or liability of the limited liability company solely by reason of being a member or acting as a manager of the limited liability company.

The Delaware LLC statute allows an LLC to engage in any lawful activity, *whether or not for profit*. See 6 Del C §18-106. Therefore, another benefit to the Delaware Series LLC is that individuals who own high-risk, non-business assets such as non-commercial boats, airplanes, vehicles, and horses may be able to place these assets into separate series to isolate potential liability. Even vacation homes and principal residences could potentially be placed in separate series.

Isolating liability among several assets is particularly useful to the owner of real estate, when some of the properties may be more susceptible to liability than others. For example, assume that the Right Family owned (1) Blanco, a manufacturing facility that produced industrial solvents, (2) Ozone, a residential rental property, and (3) Timeshare, a vacation rental. Before the Delaware Series LLC, the Right Family's alternatives were either to hold all three properties in one (undifferentiated) entity or to set up three separate entities. The first alternative would not be desirable because the liabilities associated with Blanco could wipe out the equity of Ozone and Timeshare. The second alternative is not desirable because forming and maintaining a separate entity (whether a wholly owned LLC or qualified S corporation subsidiary) for each of the properties would be costly in terms of legal, accounting, and administrative fees. In addition, several thousand dollars in annual franchise taxes would be due. The optimal solution would be to form a Delaware Series LLC with a separate series for each of the three (3) properties.

The Delaware Series LLC should be respected in California. Corporations Code §17450 states:

The laws of the state ... under which a foreign limited liability company is organized shall govern its organization and internal affairs *and the liability ... of its managers and members*.

A foreign limited liability company may not be denied registration by reason of any difference between those laws and the laws of this state. [Emphasis added.]

Notwithstanding the clear statutory provisions of Corp C §17450 and §18-215 of the Delaware LLC Act, it is conceivable that a California court could determine that the Delaware Series LLC violates public policy based on the lack of notice to trade creditors (*e.g.*, vendors), particularly in abusive situations.

Following are steps that a Delaware Series LLC may take to increase the likelihood that creditors will receive actual notice of the segregated status of a particular series.

1. Each series could adopt a fictitious business name (*i.e.*, a "dba") that is different from the registered name of the LLC. A creditor would have a difficult time showing a justifiable belief that he or she was dealing with the entire LLC.
2. The manager of a series should sign all contracts, deeds, instruments, and other documents on behalf of that series in such a manner as to put the recipient or the public at large on notice that the document is being executed solely on behalf of a particular series within a Delaware Series LLC.
3. Deeds and deeds of trust to real property should be recorded in the name of the series to provide constructive notice to creditors.

4. Each series should be adequately capitalized. There is no rule of thumb to determine with mathematical certainty what dollar amount adequately capitalizes an LLC. Adequate capitalization is determined on a case-by-case basis in view of the size, nature, and reasonably expected hazards and risks of the particular business.
5. Assets of different series should not be commingled.
6. A separate bank account should be established for each series.
7. Separate books and records should be maintained for each series.
8. Any loans between series should be properly documented, including resolutions or minutes of the manager or members of each series involved in a loan.
9. Transactions between series should be conducted in an arm's-length manner at fair market prices. When appropriate, appraisals should be obtained in connection with any sales, leases, and other transfers between series.

Delaware law allows holding separate assets in separate series in an LLC. The principal benefit of the series Delaware LLC is that it insulates the liability associated with the assets of any one particular series from the assets of the LLC generally, as well as assets held in other series. Depending upon the location of the real property, location of the promotion of a real estate syndication, this structure may be the way to hold multiple properties without having the start-up costs of separate entities. The ability to place multiple assets in a single LLC, yet insulate the liabilities, eliminates the administrative burden and expense of forming multiple LLCs to hold separate business or investment interests.

Please contact this office at hbeth@alexsonlaw.com or (949) 219-0442 to ascertain if this business structure fits your business needs.

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