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RIMON, P.C. | P: 800.930.7271 | F: 800.930.7271 | E: info@rimonlaw.com | www.rimonlaw.com

DELAWARE SERIES LLCs

A Short Introduction

By Mark R. Diamond
Partner, Rimon, P.C.

What is a Delaware Series LLC?

A Delaware Series LLC is a limited liability company organized under provisions of Delaware law that allow for the isolation of assets within separate series for liability purposes. Other states and territories have adopted Series LLC statutes: District of Columbia, Illinois, Iowa, Nevada, Oklahoma, Puerto Rico, Tennessee, Texas and Utah.

How prevalent are Delaware Series LLCs?

The ability to create a Delaware Series LLC has existed since 1997. Approximately 2.5% of all new Delaware LLCs are Series LLCs (approximately 2,000 new filings per year over the last few years).

How does a Series LLC limit liability?

The Series LLC structure allows LLCs to segregate particular assets into series so that creditors of one series do not have the right to pursue assets held in another series. As with series of other securities, such as preferred stock, different series may have different equity owners. This structure bears a strong resemblance to that of a Cayman Islands segregated portfolio company (“SPC”) which has been used with increasing frequency for offshore fund structures.

How can fund managers use a Series LLC?

A Series LLC can be used in any situation where a fund manager would otherwise create separate funds. For example, a fund may be segregated into separate series by investment strategy (conservative v. aggressive), amount of leverage or the grouping of related separately managed accounts (to allow aggregated trading of multiple accounts of a family office or other affiliated group).

How are separate series of a Series LLC created?

Series of Series LLCs are created by completion of three steps: (1) allocation to a series of LLC property or obligations or a separate allocation of profits and losses attributable to the specified property or obligations; (2) a method for maintaining separate and distinct records concerning the allocation of LLC assets from one series to another; and (3) a notice in the Certificate of Formation of the LLC of the limitation of liabilities among different series. The determining essence of a series is its “separateness” as to allocations, economic rights, record keeping and liability shields.

What rights does a series of a Series LLC have?

Under Delaware law, a series of a Series LLC is a “person.” Accordingly, it has the capacity to contract in its own name, hold title to real estate and assets, sue and be sued, create security interests and grant liens. Even though a series is a “person,” however, it is not a “legal entity” under Delaware law. The legal entity is the LLC of which the series is a part.

How can a series of a Series LLC be structured?

A series of a Series LLC can be structured in a similar manner to a separate business organization. It can have its own managers (the same or different from the LLC as a whole) and can have separate classes of securities with different rights, preferences and privileges (including senior and junior securities). Distributions of series assets are limited to the net assets of the particular series (i.e., a series cannot distribute assets if, after giving effect to the distribution, the series’ liabilities would exceed the fair value of its assets).

What are the benefits of a Series LLC to fund managers?

Series LLCs have several advantages over other types of structures. Among them are:

- Lower administrative costs from consolidation of functions that otherwise would be performed by multiple entities.
- Cost savings from use of single entity. One public document (the Certificate of Formation) is filed in Delaware for the Series LLC. The members can then designate new series without any additional public filings by preparing addenda to the Series LLC operating agreement.
- Pass-through taxation.
- Simplified corporate governance.

How are Delaware Series LLCs treated under laws of other states?

The answer to this question is not known with respect to all states. Some states, however, even those without Series LLC laws of their own, respect the form. California, for example, permits Series LLCs formed elsewhere to register with the Secretary of State and transact business in the state. Whether a court outside of Delaware will respect the liability limitation aspects of Delaware Series LLCs is also uncertain.

Will each series of a Delaware Series LLC be respected as a separate entity for purposes of the enforcement of creditors’ rights under U.S. federal bankruptcy law?

This question has no definitive answer. On one hand, an argument can be made that, although a series of a Series LLC is a “person” under Delaware law (for holding title to assets, etc.), it has not been declared by that law to be a separate legal entity and thus would not be a “person” entitled to

file a petition under U.S. federal bankruptcy law (or to have a petition filed against it). If a Series LLC as a whole is required to file for bankruptcy, the assets of all the series as well as the LLC itself may become part of the bankruptcy estate. This would subject the Series LLC as a whole to creditors of a single series and essentially destroy the liability protections that seem to be intended by the Delaware statute. On the other hand, if a series is (1) created and operated for a unique business purpose; (2) organized to evidence an intent to limit liability to the individual series; and (3) organized to alter the original property rights to items contributed to the series or to re-title property in the name of the series solely, it would seem that the series should be found to be a separate entity. Drafting the Series LLC operating agreement to emphasize the factors tending in favor of separate entity status would be the prudent approach.

What is the status of a series of a Delaware LLC for U.S. federal income tax purposes?

In 2010, the IRS issued proposed regulations addressing the tax treatment of Series LLCs. Under the proposed regulations, each series of a series LLC will be treated as an entity formed under local law and may make any federal tax election it is otherwise eligible to make independently of the Series LLC or any other series. Because each series is treated as a separate entity formed under local law for U.S. federal income tax purposes, each series should only be liable for U.S. federal income taxes related to that series. However, the IRS reserves the right to impose liability for taxes upon the Series LLC or another series within such Series LLC to the extent the debts of one series can be paid by the Series LLC or another series within such Series LLC under other provisions of local or U.S. federal law. This right should not be applicable to Delaware Series LLCs that specify in their operating agreements the liability limitations of each series.

What is the bottom line on Delaware Series LLCs?

Delaware Series LLCs provide an efficient method for structuring multiple fund strategies or groups of investors. However, uncertainty regarding the status of the form for bankruptcy and other legal purposes argue in favor of using caution in implementing this approach.

For further information concerning this topic, please contact Rimon, P.C.'s Investment Funds and Derivatives Group:

Mark R. Diamond (415-683-5472 x232; mark.diamond@rimonlaw.com)

Robin Powers (212-363-0270 x223; robin.powers@rimonlaw.com)

Thomas M. White (312-878-7131 x207; thomas.white@rimonlaw.com)

Frank Vargas (415-683-5472 x239; frank.vargas@rimonlaw.com)

Scott Raber (415-683-5472 x230; scott.raber@rimonlaw.com)

Carl Scherer (800-930-7271 x210; carl.scherer@rimonlaw.com)