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# Series LLCs:

## What Happens When One Series Fails? Key Considerations and Issues

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A handful of states permit companies to operate multiple businesses under a common organizational umbrella, referred to as a series LLC. These states are Delaware, Illinois, Iowa, Kansas, Nevada, Oklahoma, Tennessee, Texas, Utah, and Wisconsin. Both the District of Columbia and Puerto Rico have series LLC statutes as well.

The series LLC typically features a master or "parent" limited liability company (master LLC), with one or more separate businesses organized as limited liability companies (each a "series") under the master LLC. The relationships between the master and the series LLCs are determined by the limited liability company agreement and may be referenced in the articles of organization or certificate of formation filed with the state where the entity is organized. If certain statutory requirements are met, each series is liable only for obligations of that particular series and shielded from the liability of the master LLC and the other series. For example, Delaware Code title 6 § 18-215(b) sets forth requirements in the establishment of a series LLC, including notations in the operating agreement, the maintenance of records, accounting for the assets from other assets of the master limited liability company, and providing notice concerning the limitation of liabilities in the certificate of formation. Illinois additionally requires the entity to file a certificate of designation for each series. 805 Ill. Comp. Stat. § 180/37-40(b) (2012).

The nuances of the series LLC structure are beyond the scope of this article. Rather, this article focuses on a few of the key issues that arise when one series or the master LLC experiences financial distress and elects to file a petition for relief under the U.S. Bankruptcy Code. As discussed below, this scenario poses several challenging issues, many of which remain unresolved and open to interpretation.

### Overview of Basic Issues

The Bankruptcy Code provides two principal options for resolving the financial distress of business organizations – i.e., liquidation under Chapter 7 and reorganization under Chapter 11. Sections 109(b) and (d) of the Bankruptcy Code identify the category of "person" who may be a debtor in a Chapter 7 or Chapter 11 case. Those persons include "individuals, corporations and partnerships," and the term "corporation" includes, among others, "unincorporated organizations and associations." 11 U.S.C. §§ 101(9), (41). Courts have characterized LLCs as corporations under the Bankruptcy Code that generally are eligible to file a Chapter 7 or Chapter 11 case.

The primary challenge with a series LLC stems from the differing treatment of the structure under state law. For certain purposes, state law views the master LLC and the multiple series as one entity. Yet, for other purposes – primarily asset ownership and liability allocation – state law treats the master LLC and each series as separate and distinct entities. "For Secretary of State filing purposes, the series LLC is considered one entity that files a single annual report and pays a single fee. . . In other words, a series LLC is comparable to a structure with a parent LLC having multiple subsidiary LLCs except that the series LLC is considered one legal entity (at least for the Secretary of State filing purposes). . . ." Nick Marsico, *Current Status of the Series LLC: Illinois Series LLC Improves Upon Delaware Series LLC but Many Open Issues Remai*n, J. Passthrough Entities, Nov-Dec. 2006, at 35. Whether courts will respect this united but separate characterization of the series LLC structure remains unclear.

The master LLC should qualify as a debtor under Sections 101 and 109 of the Bankruptcy Code. What then happens to the series if the master LLC seeks bankruptcy protection? Does each series remain a non-debtor entity, unaffected by the master LLC's bankruptcy case? Alternatively, is each series part of the master LLC's bankruptcy case but shielded from the debts of the master LLC and other series under applicable state law and the terms of their respective operating agreements? Or are the assets and liabilities of the master LLC and each series consolidated in one bankruptcy estate?

Similar questions exist with respect to the filing of a bankruptcy case by just one series. In addition, courts may raise the more basic question of whether a series is eligible to file independently from the master LLC. Relevant case law is limited, but some basic bankruptcy concepts may help guide the series LLC through these complex issues.

### Eligibility to File Bankruptcy

As noted above, most courts characterize LLCs as corporations for purposes of Sections 101(9), 101(41), and 109(b) of the Bankruptcy Code. This characterization, in turn, permits an LLC to be a debtor in a Chapter 7 or a Chapter 11 case. Whether a master LLC or a series can file independently appears to be an open question.

Courts use different approaches in analyzing eligibility under Section 109 of the Bankruptcy Code. These approaches include the "state classification" approach, the "independent classification" approach, and the "alternative relief" approach. Although these approaches typically are used to determine if an entity is excluded from seeking federal bankruptcy relief, they are helpful in evaluating the potential treatment of series LLCs.

The state classification test turns largely on the treatment and characterization of the entity under applicable state law. *In re Auto. Prof'ls, Inc.*, 379 B.R. 746, 752 (N.D. Ill. 2007). Consequently, this test may produce different results depending on the state of organization. For example, in Illinois, the series LLC statute specifically states that each series is separate, providing that "[a] series with limited liability shall be treated as a separate entity to the extent set forth in the articles of organization." 805 Ill. Comp. Stat. § 180/37-40(b) (2012). The Illinois statute also provides that "[e]ach 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." If a series follows all of the mandates under Illinois state law to garner the series qualification, a bankruptcy court may follow the direction of the state and treat the master LLC or the series as eligible to file a bankruptcy case in its own right.

Other state statutes are silent on the classification of the master LLC or series as separate entities for all purposes. For example, the Delaware series LLC statute does not contain language similar to the Illinois statute on entity classification. It does, however, provide that "[a]ny such series may have 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." Del. Code Ann. title 6 § 18-215(a) (2012). Also, like Illinois, the Delaware statute recognizes that a properly formed series "shall have the power and capacity to, in its own name, contract, hold title to assets (including real, personal and intangible property), grant liens and security interests, and sue and be sued." Del. Code Ann. title 6 § 18-215(c) (2012). The existing case law does not address whether these provisions are sufficient to designate each series eligible to file bankruptcy in its own right.

The independent classification and alternative relief approaches to eligibility under Section 109 of the Bankruptcy Code may overlap in the context of series LLCs. Both approaches focus on the court's interpretation of the Bankruptcy Code and its underlying purposes. "The 'independent classification test' is basically a statutory construction analysis by the bankruptcy courts 'based upon their own definitions of the words of the Bankruptcy Code.'" *Beacon Health*, 105 B.R. 178, 180 (Bankr. D. N.H. 1989). Likewise, the alternative relief approach considers whether there is a state or another federal insolvency scheme already in place to address the financial distress of the entity seeking relief. Under both approaches, a court could determine that a series is an "unincorporated organization or association" eligible to file bankruptcy on an independent basis.

At least one pending Delaware bankruptcy case involves a series LLC structure. Dominion Ventures, LLC, filed a Chapter 11 case on July 19, 2011. *In re Dominion Ventures, LLC*, No. 11-12282 (Bankr. D. Del.). Its filing with the bankruptcy court states, "The Debtor serves as a management company and holds varying degrees of interest in five (5) other series LLCs (collectively, the 'Series LLCs'). The Series LLCs each own and operate (or once owned and operated) a single property." Although the bankruptcy petition seeks only to name the management company LLC as a debtor, several equity holders and members have contested the debtor's activities in the bankruptcy case. In their pleadings, these parties argue, among other things, that the debtor seeks "to sell Dumont Creek Estates Series, LLC, and Northwood Series LLC, to pay the 'debts' of 'Dominion Venture, LLC' . . . in clear violation of the provisions of the Dominion Ventures, LLC and each separate and distinct Dominion Venture LLC Series LLC operating agreement." The bankruptcy court, at the request of the equity holders and creditors and with the consent of the debtor, appointed a Chapter 11 trustee in the Dominion Ventures case. The ultimate conclusion of this case may provide some insights into the treatment of series LLCs in bankruptcy.

Regardless of whether a series can file bankruptcy on an independent basis or whether it is deemed part of the master LLCs bankruptcy case, the more important question may be what happens to the assets and liabilities of each series. Will the bankruptcy court enforce the contractual limitations on liability? This question is at the heart of the disputes in the Dominion Ventures case, and it likely will be the focus of other cases, as well as in planning discussions in entity choice matters. Some of these issues are addressed below.

### Substantive Consolidation

At its core, the key issue presented by the series LLC – whether a related company's assets are available to satisfy a debtor's obligations – is not novel. Courts have long struggled with the issue: under what circumstances should one company's assets be available to the creditors of another company? Under state law, this issue is often addressed in the context of veil piercing and whether one company is operating another company as its alter ego. (Veil piercing also is used to reach the assets of individual shareholders and frequently is a creditor-specific remedy.) In bankruptcy, these types of issues are commonly addressed under the equitable doctrine of substantive consolidation. For a general discussion of substantive consolidation and its relation to veil piercing and the alter ego doctrine, see Seth D. Amera and Alan Kolod, *Substantive Consolidation:* Getting Back to Basics, 14 Am. Bankr. Inst. L. Rev. 1 (2006).

Substantive consolidation essentially combines the assets and liabilities of the debtor's bankruptcy estate with the assets and liabilities of another company or group of companies. The result is a larger, consolidated pool of assets to pay the obligations of all of the companies' collective creditors. Although substantive consolidation typically is used to combine the bankruptcy estates of two debtors, it also can be used to combine the assets and liabilities of a debtor with non-debtor companies. Some courts have maintained that the sole purpose of substantive consolidation is to ensure the equitable treatment of all creditors. *In re Augie/Restivo Baking Company, Ltd.*, 860 F.2d 515 (2d Cir. 1988).

Different courts articulate and apply the substantive consolidation doctrine in different ways. Some courts consider "two critical factors" in assessing a motion for consolidation: "'(i) whether creditors dealt with the entities as a single economic unit and did not rely on their separate identity in extending credit; or (ii) whether the affairs of the debtors are so entangled that consolidation will benefit all creditors.'" *In re Gordon Properties, LLC*, 478 B.R. 750, 757–758 (E.D. Va. 2012) (explaining various approaches to substantive consolidation analysis) (citations omitted). Other courts require a finding that "'consolidation is necessary to avoid some harm or to realize some benefit.'" Still others follow an equities of the case approach by "focusing on equity to creditors and refusing to 'be blinded by corporate forms.'"

The factors considered by courts under the substantive consolidation doctrine often resemble those considered by courts in the alter ego/veil piercing doctrine. Thus, substantive consolidation is a case-by-case analysis. In the series LLC context, a substantive consolidation analysis may not only consider the applicable state statute and relevant operating agreements but also how the master LLC and the series conduct themselves in practice.

Notably, many of the factors considered by courts in the substantive consolidation context correspond with the requirements for limited liability established under state series LLC statutes. For example, series LLC statutes require each series to maintain separate books and records with separate accounting of their assets and liabilities. This often is a factor considered under substantive consolidation. Moreover, the Illinois series LLC statute requires the master LLC to file a series designation for each series and that "the name of the series with limited liability must contain the entire name of the limited liability company and be distinguishable from the names of the other series set forth in the articles of organization." 805 Ill. Comp. Stat. § 180/37-40(c) (2012). These provisions, if followed, might mitigate the concern of creditors' reliance and expectations, which often is a focus of the substantive consolidation analysis. Nevertheless, parties must recognize the potential of substantive consolidation even where organizational forms are respected. *Gordon Props*, 748 B.R. at 758–760 (remanding for bankruptcy court to re-evaluate equities of the case from the creditors' perspective).

Parties establishing a series LLC should evaluate the substantive consolidation case law in their jurisdiction and consider the doctrine in forming and operating their business venture. Although there is no certainty in this analysis, it can inform the process in a meaningful way.

In addition to the issues above, a master LLC and its series should consider other issues that often arise in the general context of LLCs and bankruptcy. For example:

*In re 20 Bayard Views, LLC*, **445 B.R. 83 (Bankr. E.D.N.Y. 2011) (application of cramdown provisions of Section 1129(b) in LLC context)**

*In re National Jockey Club*, **451 B.R. 825 (Bankr. N.D. Ill. 2011) (ability of bankruptcy trustee to pursue turnover claims against debtor LLC's former president)**

*In re Mervyn's Holdings, LLC*, **426 B.R. 488 (Bankr. D. Del. 2010) (ability of debtor LLC to pursue breach of fiduciary duty and fraudulent conveyance claims)**

*In re Ice Oasis, LLC*, **No. 08-31522 TEC, 2008 WL 5753355 (Bankr. N.D. Cal. Nov. 7, 2008) (authority of LLC to file bankruptcy case when operating agreement is silent)**

*In re HRP Myrtle Beach Holdings, LLC*, **No. 08-12193, 2008 WL 4442606 (Bankr. D. Del. Sept. 29, 2008) (postpetition financing and cash collateral issues in LLC context)**

*In re JNS Aviation, LLC*, **376 B.R. 500, (Bankr. N.D. Tex. 2007) (ability of creditor of debtor LLC to pierce the veil of limited liability to reach assets of owners)**

*Milford Power Co., LLC v. PDC Milford Power, LLC*, **866 A.2d 738 (Del. Ch. 2004) (enforceability of ipso facto clause in operating agreement)**

*In re Am. Media Distributors, LLC*, **216 B.R. 486 (Bankr. E.D.N.Y. 1998) (impact of automatic stay of Section 362 of the Bankruptcy Code on the arbitration rights of a non-member with respect to claims under the operating agreement)**

## Conclusion

The law governing the rights and remedies of a financially-troubled series LLC is still developing. Parties using, or contemplating using, the series LLC structure should recognize the lingering uncertainty concerning the treatment of a master LLC and its series under federal bankruptcy law and proactively consider alternative structures and exit strategies in the planning stages. Although parties cannot necessarily avoid bankruptcy with advance planning, they can strengthen certain aspects of the series LLC structure with state law tools. For example, parties should clearly designate the allocation of asset ownership, liabilities, and the assets available to satisfy those liabilities; ensure that creditors' interests are properly perfected against the correct assets; and comply in all respects with the applicable series LLC statute.

In addition, parties should consider ways to use state LLC and commercial law to enhance the likelihood that the parties' intentions regarding the state law structure are respected in any subsequent bankruptcy case. For example, parties might endeavor to foster greater protection for the equity value of healthy series through contractual provisions – both in the operating agreement – concerning types and amount of debt that series may incur – and in creditor contracts – through acknowledgements of the assets available to pay obligations, waivers of deficiencies in the context of secured debt, and limiting the use of cross-collateralization and cross-acceleration provisions. These steps will not guarantee the protection of the series LLC structure in bankruptcy, but they will help all parties dealing with the series understand the construct and may foreclose certain arguments based on parties' expectations.

Similarly, sponsors and managers should evaluate their disclosure obligations to investors under applicable law and consider what information concerning insolvency risks might be required to satisfy such obligations. Although disclosing uncertainty in the series LLC structure might hold negative implications, those must be weighed against potential litigation involving sponsors and managers premised on inadequate disclosures. Moreover, lawyers should consider the effect of this uncertainty on the parameters and content of opinion letters.

Given the operational and financing advantages to the series LLC for some businesses, the uncertainty surrounding bankruptcy and series LLCs becomes part of the cost-benefit analysis. Parties should not necessarily avoid the structure because of this uncertainty, but they should consider its overall impact, including potential negative consequences on the rights and remedies of owners and certain creditors and on the cost of capital.

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**ADDITIONAL RESOURCES**

For other materials related to this topic, please refer to the following.

**Business Law Today**

**Series LLCs: Let's Give the Frog a Little Love**

By Dominick T. Gattuso
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