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James D. Blake*

ABSTRACT

The series LLC is a business structure with the potential to usher in innovative solutions for risk structuring, asset protection, business reorganization, and organic business growth. Yet, because it was originally developed for use by "heavy-weight" members of the corporate and financial services industry, and because only a handful of states have adopted it by statute, many questions about the feasibility of series LLCs for small or medium-sized companies remain unanswered. Some authors have promoted the series LLC as a promising vehicle for a diverse range of small businesses. This article takes a more cautious approach, exploring structural and membership issues in light of tax and bankruptcy law, forewarning potential pitfalls with industry-specific examples, providing solutions for potential obstacles, and suggesting additional legal developments that could heighten the series LLC's performance as an advantaged vehicle for investment and innovation.

I. INTRODUCTION

Recent decades have witnessed an explosion of new business structures domestically and abroad. In the U.S., "[m]ost states have gone from a statutory regime [with] four prevalent business models . . . to one [with] at least two . . . and as many as five new choices in some jurisdictions."¹ This expansion in the U.S. has been driven, in part, by competition from offshore financial centers that have attracted global financial services. Vermont's virtual company is the latest entity to be developed. It operates "without a physical headquarters, [with no] actual paper filings, and [with] directors' meetings [conducted online]. If it succeeds, it could emerge with the nation's first virtual tech corridor." Alan Rappeport, Vermont Wants to Be the "Delaware of the Net", CFO.com (June 30, 2008), http://www.cfo.com/article.cfm/11654091/c_2984311/?f=archives.

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¹ Carol R. Goforth, The Series LLC, and a Series of Difficult Questions, 60 ARK. L. REV. 385, 385 (2007). Vermont's virtual company is the latest entity to be developed. It operates "without a physical headquarters, [with no] actual paper filings, and [with] directors' meetings [conducted online]. If it succeeds, it could emerge with the nation's first virtual tech corridor." Alan Rappeport, Vermont Wants to Be the "Delaware of the Net", CFO.com (June 30, 2008), http://www.cfo.com/article.cfm/11654091/c_2984311/?f=archives.
business and investment through favorable tax environments and innovative company structures.\textsuperscript{2}

The protected cell company is an offshore innovation now planted in U.S. soil. Known in some jurisdictions as "segregated accounts companies" or "segregated portfolio companies,"\textsuperscript{3} this entity consists of related "cell" companies, generally arranged as a core cell and any number of sub-cells. Each cell is only responsible for its own assets and liabilities, and even the core cell can be insulated from the liabilities and insolvency of sub-cells.\textsuperscript{4}

In the U.S., a number of states have introduced two general variations of this structure: the protected cell insurance company,\textsuperscript{5} and the series LLC. As the name implies, the protected cell insurance company structure is generally limited to serving the insurance industry,\textsuperscript{6}

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  \item \textsuperscript{4} Id.
  \item \textsuperscript{5} Rating Protected Cell Companies, A.M. Best Methodology 4 (Mar. 4, 2008), http://www.ambest.com/ratings/methodology/ProtectedCellCaptives.pdf; see also Gordon A. Schaller & Scott A. Harshman, Use of Captive Insurance Companies in Estate Planning, 33 ACTEC J. 252, 253 (2008) (indicating that the following states are among those that have modern captive insurance statutes: Utah, Nevada, Montana, Kentucky, Arizona, Vermont, Delaware, District of Columbia, and Hawaii).
\end{itemize}
parallel to its original purpose in offshore jurisdictions. The series LLC, however, has been adopted and promoted in a number of states for a broad (or unlimited) range of business activities, and it is probably used most frequently in real estate.

Because the protected cell structure was originally developed for use by "heavy-weight" members of the corporate and financial services industry, many questions about the feasibility of series LLCs for small or medium-sized companies remain open. Some commentators promote it as a promising vehicle for diverse business purposes, even for small businesses such as "farms, restaurants, [ ] software [firms,] and bio-tech start-ups," among others. This article takes a more cautious approach, exploring the series LLC structure and membership issues in light of federal income tax and bankruptcy law, forewarning potential pitfalls with industry-specific examples, and suggesting solutions to overcome potential obstacles.

Part II explores the offshore development of protected cell structures, the emergence of the series LLC, and the series LLC's promise as a flexible and efficient business vehicle. Part III discusses series LLCs as business entities and describes the tax consequences that flow from the structure of series LLCs and from the composition of members' interests. Part IV explores bankruptcy issues that create unique challenges for series LLCs, including substantive consolidation and the downside risk that a series entity may face if classified as a single asset real estate company ("SARE"). Part IV goes on to explore structural solutions for series LLCs and SARE-resistant mechanisms. Part V concludes that the series LLC is generally not an appropriate structure for small and medium-sized businesses operated by relatively unsophisticated business people (be they farmers or bio-molecular engineers). Many hidden challenges await small businesses attempting to segregate operations and assets through the series LLC structure. Yet, larger scale companies may successfully implement the series LLC to potentiate innovative solutions for risk structuring, asset protection, business reorganization, and organic business growth.

7. See infra text accompanying notes 10-32.
8. Howard J. Levine, Letter to IRS re IRS National Office Project on Delaware Series Limited Liability Company, in ALI-ABA COURSE OF STUDY, CREATIVE TAX PLANNING FOR REAL ESTATE TRANSACTIONS 453, 456 (2008) ("Over the years, we have most often encountered [the series LLC] where partners form a partnership to acquire and develop real estate properties . . . [and] to separately limit liability with respect to each property development . . . ").
II. BACKGROUND ON PROTECTED CELL COMPANIES AND THE SERIES LLC

From its emergence in the 1960s, the protected cell company has spread across the globe, adapting new characteristics in various jurisdictions. This structure has been "ideal for . . . captive insurance companies, multiple tranche debt issue vehicles, securitisation and derivative transactions." It has also been used extensively in the Cayman Islands for hedge funds and in other jurisdictions for mutual funds. With the emergence of the series LLC in the U.S., the protected cell structure became available for an unlimited range of uses, and this entity shows promising advantages for companies that can effectively harness its flexibility and efficiency.

A. The Evolution of the Protected Cell Company and the Series LLC

The protected cell company initially evolved as an innovative business vehicle serving the offshore captive and "rent-a-captive" insurance industry. "[C]aptives are insurance companies that are owned by their policyholders," and are designed to achieve tax advantages and other strategic goals by self-insuring some risks while purchasing cheaper and more flexible coverage for other risks on the secondary insurance market. Bermuda became the birthplace of the first captive insurance company in the 1960s, and by the late 1970s, a

10. See Weaver et al., supra note 3, at 2.
13. See Rating Protected Cell Companies, supra note 5, at 3.
15. See Schaller & Harshman, supra note 5, at 258 ("In general, the Internal Revenue Code permits property and casualty insurance companies certain deductions against taxable income, including premium income and investment income, that are not available to regular corporations. These deductions may significantly reduce, if not eliminate, an insurance company's taxable income from premiums received or investment income earned in a given year.").
16. Roger Gillett & Robert Davis, Rent-a-Captives: Why Own When You Can Rent?, John Liner Rev., Winter 2005, at 1-2 ("Organizations may establish captives to obtain coverage that is unavailable in the traditional marketplace. More often, however, a company establishes a captive with the goal of crafting customized insurance contracts while lowering its insurance costs. Lower costs accrue, in part, through underwriting profit and investment income on premium cash flow and claims reserves. The use of a captive also allows a company with a good loss history to pay premiums that reflect its own experience rather than the risk profile of its industry.").
derivative model emerged: "rent-a-captives." The rent-a-captive model allows smaller, "unrelated companies [to] pay a fee to 'lease' capital, surplus, and an insurance license from a captive sponsor . . . . [The Captive sponsor] separate[s] the assets and liabilities of each renter — or cell — from those of the other renters . . . ."

Early rent-a-captives segregated renters’ assets and liabilities within the company solely through contract. Statutory recognition of the protected cell structure emerged in Bermuda in the early 1990s under 140 private legislative acts that only granted specific companies the right to organize segregated portfolio companies. Today, Bermuda remains the “[t]he largest venue for captives[,]” but in 1997 Guernsey became the first offshore jurisdiction to pass public legislation offering the protected cell company structure. Today Guernsey domiciles the largest number of protected cell companies in Europe.

As offshore financial centers captured market share in the captive and rent-a-captive insurance industry, U.S. jurisdictions were simultaneously stepping up efforts to compete. “Vermont aggressively sought captive [insurance] business starting in 1979,” offering “low initial capital requirements, an annual audit, and a hefty dose of self-regulation.” Delaware also initiated captive-enabling legislation in the 1980s with the specific intent of luring Bermuda-based insurance companies, but “[d]espite the progressive nature of Delaware’s captive

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18. See Rating Protected Cell Companies, supra note 5, at 3.
22. Schaller & Harshman, supra note 5, at 254 (“Other Caribbean captive jurisdictions include the Cayman Islands, the British Virgin Islands, and Barbados.”).
23. Ogier Client Briefing, Joint Ownership and Ownership in Common of Guernsey Real Property, 1 (Apr. 2006), http://www.ogier.com/Publication%20Library/Guernsey_Joint_Ownership/pdf ("Guernsey is a self-governing dependency of the British Crown and does not form part of the United Kingdom. By constitutional convention established over some 900 years the Island has complete autonomy in all matters of internal government, including taxation.").
24. Weaver et al., supra note 3.
25. See O’Brien, supra note 21 ("Bermuda passed the Segregated Accounts Companies (SAC) Act in 2000 but before that, many companies operated in Bermuda as rent a captives without the benefit of statutory separation of accounts.").
27. See Morriss, supra note 2, at 57.
statute, even as amended in 1988 and 1995, captive insurers did not flock to Delaware.”

To be globally competitive, U.S. financial centers needed to “sweeten the deal” with protected cell structures like those offered offshore. Delaware led the way in 1996 when it passed the first legislation to recognize the series LLC – a limited liability company that can issue an unlimited number of sub-series entities. Like the protected cell company structure, the series LLC is designed such that the "debts, liabilities, and obligations relating to one series are enforceable only against the assets of that series and not against the assets of the LLC generally or the assets of any other series.”

For its time, this was a tremendously progressive statute because it was the first public legislation to offer the protected cell structure for all business purposes – not just for insurance or the finance industry. A number of other states, including Iowa, Illinois, Nevada, Oklahoma, Tennessee, and Utah subsequently developed series LLC statutes.

As will be discussed in Part III, Illinois series LLC legislation provides a number of advantages over the Delaware model, and may be a useful touchstone for series LLC best practices.

B. The Series LLC as a Flexible and Efficient Business Vehicle

In addition to the risk protection that can be achieved through segregating assets in separate series entities, the series LLC offers a host of other benefits. The most widely recognized utility is its documentary efficiency: “[b]usiness objectives that [previously] required the creation of multiple documents and multiple LLCs may now be achieved with the creation of only one document, which will generally be significantly less expensive for the client.” These savings are further compounded by “reduce[ed] legal, accounting and administrative

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32. See infra notes 45-59 and accompanying text.

fees in certain circumstances." One author calculates that start-up and accounting costs for establishing and operating ten Delaware LLCs may be around $20,000 more expensive than forming a Delaware Series LLC with ten sub-series entities. This is likely to be a conservative estimate for some kinds of businesses, considering that it does not include specialized regulatory or registration costs that some businesses would otherwise incur for each entity.

The series LLC also offers interesting possibilities for like-kind swaps and generally allows for efficient transfers of property. For example, transferring an undivided interest in real property is much more difficult than transferring an LLC interest, "a relatively simple process . . . governed by statute in the absence of contrary provisions in the LLC's operating agreement." Transferring a sub-series, rather than the real property itself, enables a company to avoid "the associated real estate closing costs," including "transfer tax costs, recording multiple deeds and the related cost, [and] title issues." Of course, these kinds of transfers are already available with ordinary LLCs. However, the series LLC offers an added bonus: "tax-free transfers within the LLC." A series LLC can create new series entities at any time, and may achieve some of the effects of a sale without necessarily creating a taxed transaction, even where the property is not "like kind." Too aggressive of an approach, however, may still result in taxable transactions.


35. Nathaniel V. Thompkins, At Glacier Speed, the Fastest Growing Entity of Choice, the Series LLC?, 4 (2006), http://nm-ny-pa-law.net/At_Glacier_Speed.pdf. Note, however, that since the time that Thompkins' article was published, California has determined that it will recognize series entities as separate LLCs for the purpose of state franchise tax, diminishing some of the potential savings mentioned in the article. See Dibby Allan Green, Delaware Series LLC or LP: California's Recognition & Tax Reporting (2008), http://www.taxlawsb.com/resources/BusTax/SeriesLLC.htm (last visited Nov. 28, 2010).

36. See generally Louis S. Weller, Selected Like-Kind Exchange Issues, in Practicing Law Institute Tax Law and Estate Planning Course Handbook Series 883, 939-40 (2003), available at 562 PLI/Tax 883 (Westlaw). A like-kind swap is a transaction whereby two or more parties exchange property of similar kind and do not incur tax liability because the similarity of the property traded is determined to produce no accession to wealth or profit. See I.R.C. § 1031 (2006).


38. See Lesk & De Vellis, supra note 37, at 549.

39. See Gold, supra note 34, at 20.


41. See Terence Floyd Cuff, Series LLCs & The Abolition of the Tax System, in Tax Planning for Domestic & Foreign Partnerships, LLCs, Joint Ventures & Other Strategic
If the reduced start-up costs, reduced transaction costs, and reduced taxes are not enough to ensure a company’s success, the series LLC structure still has a few benefits to offer. Whereas an insolvent LLC “would not be allowed to make a distribution under the Delaware LLC Act, a distribution can be made from a [sub-]series to the extent that the fair value of series’ assets exceeds its liabilities.”42 In other words, if a master LLC and nine out of ten of its series entities are unprofitable, the profitable series may still make distributions. Similarly, the insolvency of one series does not affect any other series, making it a potentially useful asset protection tool, assuming that courts in non-series LLC jurisdictions will respect the series as a separate entity.43 Part III explores the corporate personality of series LLCs and their status as a tax entities vis-à-vis permutations of series LLC structures and the terms governing members’ interests.

III. Unveiling the Paradox of Series LLCs

The paradox of the series LLC is that it attempts to be both singular and multiple – ideally a single entity for registration, regulation, and taxes,44 yet multiple entities for business and asset protection purposes. Originally, the legal status of series entities was unclear, but recent developments have illuminated the issue. Similarly, series entities’ status as tax entities has been much conjectured, yet there is now a reasonable amount of certainty about how the IRS will classify single and multi-member series LLC entities. Even so, individual states may still develop different classification and tax schemes. Additional developments in tax law could improve the series LLC’s performance as an advantaged vehicle for investment and innovation, particularly by allowing multi-member series entities to be disregarded according to safe harbor provisions that adequately account for enterprise value, commonality of ownership, and other considerations.

A. Series LLCs as Business Entities

Originally, series entities in Delaware did not enjoy the full rights and powers that typical business entities possess. Without legislation specifically enabling series entities to enter transactions in their own name, they could not “borrow money, maintain bank accounts, enter

42. See Goforth, supra note 1, at 387.
43. See infra notes 94-153 and accompanying text.
44. This is a generalization. A series LLC organized as an open-end investment company may desire for each series entity to be a separate tax partnership.
into legally binding contracts, [and could not] sue or be sued.”

The statute did not give series entities a right to own property, but instead provided for “segregating assets and liabilities (and management) within the LLC.” In 2007, a Delaware court confirmed the non-entity status of series entities, stating, “I do not find that Series B was an entity at all, but merely a ‘series interest’ of GxG Management LLC . . . GxG Management is the appropriate party to pursue the claims raised in this case, both tort and contract.” Thus, in the early development of series LLC law in Delaware, the master LLC alone had the right to enter transactions on behalf of series entities. It would also have the right, but not the duty (unless established by contract), to sue on behalf of series entities.

Illinois took a different approach. The Illinois series LLC statute provided more flexibility, enabling a series to be “treated as a separate entity to the extent set forth in the articles of organization,” and specifically stating 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.” This was an important development that appeared to give Illinois series LLCs an advantage over their Delaware cousins, who were still treated as second-class citizens.

Delaware did not follow in line with Illinois until after the court in GxG Management held that a series was a non-entity. The subsequent amendments allow series entities to contract for and hold title to real, personal, and intangible property. Additionally, the law is flexible regarding how a series may hold assets: “directly or indirectly, including in the name of such series, in the name of the limited liability company, through a nominee or otherwise.”

45. Craig A. Gerson, Taxing Series LLCs, 45 TAX MGMT. MEMORANDUM 75, text preceding note 12 (2004).
48. See 805 ILL. COMP. STAT. 180/37-40(b) (2005). It also authorizes “consolid[ation]” of the operations of several series “to the extent permitted under applicable law,” and provides that two or more series may elect to contract jointly or elect to be treated as a single business for qualification purposes to do business in Illinois or any other state without affecting the limitations of liability set forth in the statute. Id.
49. Id. See also Goforth, supra note 1, at 388-89.
50. See GxG Mgmt., 2007 WL 1702872, at *2.
51. DEL. CODE ANN. tit. 6, § 18-215(c) (2007).
52. tit. 6, § 18-215(b).
sue and be sued in its own name, and may grant liens and security interests.\textsuperscript{53} To a large extent, the amendments to the Delaware statute eliminated the differences between series LLCs in Delaware and Illinois.

The Illinois series LLC statute is still distinguishable from its Delaware counterpart, however, because Illinois imposes additional provisions on the name, registration, and termination of series entities. Illinois raised the bar by requiring that "[t]he name of the series . . . 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."\textsuperscript{54} Illinois also requires series LLCs to file separate "certificates of designation"\textsuperscript{55} to create and terminate any series, arguably providing better notice to the public about the identity of the series.\textsuperscript{56} As will be discussed in Part IV, Illinois' additional filing and notice requirements may provide advantages to series LLCs in bankruptcy, fortifying the liability shields between the series LLC entities against equitable consolidation or other "veil-piercing" actions.\textsuperscript{57}

In Delaware, by contrast, a master LLC files a "certificate of formation" that contains a limited liability notice of the master LLC and its series.\textsuperscript{58} Thereafter, the LLC may create or terminate an unlimited number of series entities without any state filing because there is "no requirement that any specific series of the limited liability company be referenced in such notice."\textsuperscript{59} While the lack of name and registration requirements and expenses are certainly a benefit, all series LLCs would be wise to consider the spirit and insolvency-planning advantages of the Illinois provisions, taking extra care to provide notice to third parties and to distinguish the names of various entities.

B. Structuring Series LLCs for Flow-Through Taxation

The majority of series LLC literature expresses uneasiness about the uncertainty of series LLC tax treatment.\textsuperscript{60} One commentator states, "[t]here is virtually no authority on the issue of whether [multi-member series entities owned in the majority by a common set of members] would be treated for tax purposes as separate partner-

\textsuperscript{53} tit. 6, § 18-215(c).
\textsuperscript{55} 180/37-40(d).
\textsuperscript{56} See Murray, supra note 46, at 10.
\textsuperscript{57} See text following note 114.
\textsuperscript{58} Del. Code Ann. tit. 6, § 18-215(b) (2007).
\textsuperscript{59} Id.
\textsuperscript{60} See, e.g., CCH Staff, Eds., Guide to Limited Liability Companies 87 (CCH Tax & Accounting, 2005).
Yet the IRS recently provided some guidance with Private Letter Ruling 20-08-030-04, dispelling much uncertainty.

One survey of accountants indicated that some series LLCs are reporting as a single entity while others are reporting the master LLC and series entities as separate tax entities. Without more information, this anecdote is of little use, because a company’s status as a series entity under state law does not determine whether a series is a taxable entity. Instead, the underlying economic arrangement, as embodied in the structure of the series LLC and the members’ respective interests is the critical question.

Limited liability companies are generally utilized as “flow-through” tax entities, meaning that profits and losses are passed directly to the members and are not taxed at the entity level. But series LLCs or series entities may elect one of three tax elections, depending on their membership structure. Although the “Check the Box Regulations” permit a non-corporate business entity to file as a corporation, many companies organized as an LLC wish to avoid the “double taxation” associated with the corporate form. Alternatively, an entity with two or more members may choose the default partnership election. An entity with a single “owner” (such as a single-member series) may be taxed as a corporation or may be disregarded as an entity that does not report separately from its owner.

Tension between series LLCs and Check the Box Regulations emerges where the master LLC wishes to issue multi-member series entities (perhaps to raise capital), but the master LLC also wants to enjoy the tax benefits of a disregarded entity. Under a plain reading

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61. See Levine, supra note 8, at 457.
63. See Green, supra note 35.
64. See Treas. Reg. § 301.7701-1(a)(1) (as amended in 2009) (“Whether an organization is an entity separate from its owners for federal tax purposes is a matter of federal tax law and does not depend on whether the organization is recognized as an entity under local law.”).
66. LLCs and partnerships both receive flow through tax treatment.
69. Strictly speaking, members are not owners of an LLC, but instead have membership interests in the LLC. In the context of Check the Box Regulations, however, a member is nominally classified as an owner. See Treas. Dept., IRS Form 8832, Entity Classification Election (2010) available at http://www.irs.gov/pub/irs-pdf/f8832.pdf.
of the Check the Box Regulations, a business entity with two or more owners is not disregarded, but may elect partnership taxation.\textsuperscript{71} Such an election eliminates the master LLC’s ability to offset profits and losses among series entities because they will be separate tax partnerships, not disregarded entities. Further, the series entities, as separate tax entities, may encounter other tax disadvantages if they later desire to merge.

Most commentators and practitioners appear to agree that multi-member series entities with little common ownership should be treated as separate tax entities.\textsuperscript{72} Supporting this position, some analogize the issue to developments in Delaware and Massachusetts business trusts: “[A]s early as 1949, the Tax Court held that each series of a Delaware statutory trust may be regarded as a separate taxpayer,”\textsuperscript{73} and the IRS took this position in relation to a Massachusetts business trust in 1984.\textsuperscript{74} Since that time, the IRS has taken a similar position in a number of private letter rulings.\textsuperscript{75}

Yet, in an open letter addressed to the IRS, Levine argues that multi-member series LLC entities should be disregarded for tax purposes where there is a “very high level of common ownership, [an] overall common business purpose . . . [and] all the partners hold themselves out as partners in a single partnership.”\textsuperscript{76} He claims that this would “accomplish[ ] the same business objectives” that are currently achieved using an ordinary LLC as a holding company for subsidiary LLCs, with the difference being that series LLCs could save costs via the series LLC’s efficiency in documentation and administration.\textsuperscript{77} What Levine fails to emphasize is that a loose policy that liberally disregards multi-member series entities could enable additional business objectives and may fundamentally change a company’s operational and investment strategy.\textsuperscript{78}

\textsuperscript{71} Treas. Reg. § 301.7701-3(b)(1)(i) (as amended in 2006). The same interpretation was asserted recently in a private letter ruling. I.R.S. Priv. Ltr. Rul. 20-08-030-04 (Jan. 18, 2008).
\textsuperscript{72} See Levine, supra note 8, at 457 (citing Gerson, supra note 45). See also Cuff, supra note 41.
\textsuperscript{73} See Mooney, supra note 30, at text accompanying note 79 (citing Nat’l Sec. Series – Indus. Stocks Series v. Comm’r, 13 T.C. 884 (1949)).
\textsuperscript{76} See Levine, supra note 8, at 458 (citing Thomas M. Stephens & Marc L. Schulz, Segregating Assets Within a Single Partnership, TAXES, Mar. 2000, at 231, 239).
\textsuperscript{77} See Levine, supra note 8, at 458.
\textsuperscript{78} Levine addresses the “like-kind” issue abstractly in a single sentence at the beginning of his letter. See Levine, supra note 8, at 455. However, when he discusses the effect of disregarding multi-member series entities, he only discusses documentary efficiencies that would result and omits any mention of positive tax consequences.
If multi-member series entities could be disregarded, then master LLCs could offset profits and losses among multiple partnerships, enabling a hedging effect that would probably influence investment strategies and objectives. Perhaps more importantly, disregarded multi-member series entities could open a Pandora's box of (not so) "like-kind" exchanges with a potentially infinite number of members and disregarded partnerships. Would this lead to the "abolition of the tax system," as one practitioner posits? This author suggests that well-crafted safe harbors with provisions for enterprise value, commonality of ownership, marketing and representations to the public, and other factors could prevent abuse, set standards for best practices, and enable series LLCs to achieve new heights of innovation.

In any case, the IRS has not yet indicated that it will deviate from the current practice of taxing multi-member business entities as corporations or partnerships. Until such a time, a series LLC wishing to benefit from the tax advantages offered by disregarded entities should be structured as the sole member of its series entities. Although the master LLC will be the "owner" of the series entities, members of the master LLC can achieve the effect of direct interests in series entities through allocations in the master LLC's operating agreement.

C. Structuring Members’ Interests in Series LLCs

In general, allocations of LLC membership interests can be flexible, as long as they have substantial economic effect. In simple terms, that means "allocations must be based on real economic factors...they can’t simply be used to shift income around to reduce an owner’s income taxes." Often, “suspect tax allocations” emerge where “an item of income or loss in one section of the [agreement receives different] treatment...elsewhere in the agreement.” Allocations that are disproportionate are called special allocations and are permissible if the company adopts and implements safe harbor provisions in its op-

79. However, if there is a high degree of common ownership, some of the expansion may be limited.
80. See Cuff, supra note 41, at 343.
81. CCH TAX LAW, supra note 65, at § 3.19-3.20.
82. See I.R.C. § 704(b) (2006).
83. ANTHONY MANCUSO, NOLO’S QUICK LLC 99 (4th ed. 2007).
84. Allen B. Ellentuck, The CPA’s Role in Reviewing LLC Allocations, AM. INST. CPAs (Oct. 1, 2007), http://www.aicpa.org/Publications/TaxAdviser/2007/oct/Pages/TheCPASRoleinReviewingLLCAllocations.aspx. When different sections of an operating agreement conflict, “[g]enerally, the contribution and distribution provisions of an agreement are deemed to control the profit and loss allocation provisions.” Id.
If a company does not meet the safe harbor provisions and the special allocation does not have substantial economic effect, the IRS will reallocate the partners' interests in the LLC "based on the underlying economic relationships of the partners, [including] the partner's contributions to the partnership, the partner's interests in the partnership's economic profits and losses, and the partner's rights to operating and liquidating distributions." 87

There is no requirement for a member to be allocated a "share of all profits in the partnership or [to] have a direct profit interest in every element of a partnership's activities." 88 However, "special allocations [are] frequently . . . found within a single partnership," and the outer boundaries or "limits on tax planners' ability to effect such schedular allocations within a single tax partnership are not well-defined." 89 Revenue Ruling 55-39 provides insight at the extreme end of the spectrum, stating that property held by an entity on behalf of a partner who retains "all of the incidents of ownership, including the right to be credited with income and profits therefrom and all rights of control . . . cannot qualify as jointly owned property." 90 Thus, the

86. See Kirk O. Broberg, Partnership: Understanding the Requirements of Special Allocations, ADVOCATE, Sept. 1996, at 16, 17. There are three basic safe harbor provisions:

(1) the partnership must determine and maintain proper "capital accounts";
(2) upon liquidation of the partnership or a partner's interest, liquidating distributions must be made in accordance with the positive capital account balances of the partners; and
(3) if any partner has a deficit balance in his or her capital account following the liquidation of the partnership or the liquidation of that partner's interest, the partner is unconditionally obligated to restore to the partnership an amount equal to the deficit balance in that partner's capital account.

Id. Because (3) would have the effect of negating members' limited liability, an alternate provision states that:

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special allocations will have economic effect if, in addition to satisfying the first two requirements for economic effect mentioned above, the partnership agreement prohibits any allocations or distributions from being made that would cause a deficit in a partner's capital account balance, or would cause a deficit greater than the amount the partner has agreed to restore upon liquidation.

Id.

87. Id. at 18; see, e.g., I.R.S. Priv. Ltr. Rul. 96-22-014 (Feb. 27, 1996) (noting the 11th Circuit's holding that a withdrawing partner constructively received a cash distribution because a lender entered into a "hold harmless" agreement with an LLC's purchasing partner, effectively terminating the withdrawing partner's liability without expressly releasing the partner from her personal guarantee).

88. See Levine, supra note 8, at 458 (citing Thomas M. Stephens & Marc L. Schultz, Segregating Assets Within a Single Partnership, TAXES, Mar. 2000, at 231, 240) (unequal distribution of membership allocations "should not be determinative as to whether the income is partnership income").

89. See Cuff, supra note 41, at 347.

90. Rev. Rul. 55-39, 1955-1 C.B. 403. This conforms to the substance-over-form approach, whereby "tax ownership of an asset generally is determined by reference to the locus of risk of
partner was deemed to be the tax owner of the property. But what if the partner had only retained ninety-nine percent? At first glance, one percent might seem to be a mere peppercorn, but what if the series holds high-end real estate valued at $10 million? Clearly, a one-size-fits-all approach to this issue would be misguided.

Even amid the uncertainty surrounding series LLC taxation, some practitioners are cautious about achieving too much clarity. In Levine’s open letter to the IRS, he implores the IRS for guidance, but states that “it would [not] be appropriate (or supportable) for a published ruling to provide an absolute litmus test as to a particular required percentage of majority common ownership, except, perhaps, in the context of a safe harbor which would not be exclusive.” In slight contrast, this author suggests that safe harbor provisions could achieve a reasonable solution, setting limits on multi-member series entities and limiting individual members’ majority interest in series entities. A fairly clear litmus test would arguably be advantageous, providing more certainty and enabling informed decision-making and structuring. But to avoid the peppercorn problem of arbitrary percentages that do not reflect the underlying value of members’ interests, these models of guidance should be scaled to the series entities’ enterprise value and the value of the members’ interests.

IV. STRUCTURING SERIES LLCs FOR ASSET PROTECTION AND BANKRUPTCY

The series LLC was developed, in part, to isolate and protect assets in separate series entities, adapting the current practice whereby “[a]ttorneys advise clients to form multiple LLCs, placing a single asset in each LLC.” To date, there are no published cases indicating how

91. Id.

92. See In re Albright, 291 B.R. 538, 541 (Bankr. D. Colo. 2003) (“To the extent a debtor intends to hinder, delay or defraud creditors through a multi-member LLC with ‘peppercorn’ co-members, bankruptcy avoidance provisions and fraudulent transfer law would provide creditors or a bankruptcy trustee with recourse.”) (citing 11 U.S.C. §§ 544(b)(1) and 548(a) (2006)). While there is no fraudulent transfer issue in the 1% ownership discussed above, the image of the peppercorn is a helpful metaphor to illustrate the use of the most minimal arrangement necessary to circumvent the “letter of the law.”

93. See Levine, supra note 8, at 459.

94. See Stein, supra note 12, at 20.
this structure will perform in jurisdictions without series LLC statutes. Yet even without such guidance, some commentators are optimistic about its promise for "small and medium-sized businesses . . . such as organic farms, restaurants, and software and bio-tech start-ups . . . sometimes owned and operated by less-sophisticated investors [who] might benefit from using the [s]eries LLC form."95

With a more cautious approach, Part IV discusses the doctrine of substantial consolidation and the unique threat it poses to series LLCs. The next section addresses the use of series LLCs to hold real estate, and the bankruptcy ramifications of being declared a SARE. We then explore strategies that series LLCs may use to avoid SARE status. Throughout the discussion, these issues are explored in the context of the businesses noted above – technology companies, farms, restaurants, and other businesses – illustrating the challenges that face small to medium-sized companies wishing to organize as series LLCs.

A. Series LLCs and the Threat of Substantive Consolidation

Equitable or substantive consolidation is a legal theory96 whereby a bankruptcy court may satisfy the debts of interrelated entities by treating them as a single entity.97 This is an alternative theory that may achieve a result similar to "alter ego" and other "veil-piercing" theories,98 which "the Delaware [series LLC] statute specifically prohibits."99 The modern or liberal trend of consolidation "arises from . . . increased judicial recognition of the widespread use of interrelated corporate structures by subsidiary corporations operating under a parent entity's corporate umbrella for tax and business planning pur-

95. See Gattuso, supra note 9, at 36 (emphasis added).
98. The corporate veil doctrine is based upon the legal fiction whereby a company is recognized as a juridical person distinct from its individual constituents. See 18 AM. JUR. 2d Corporations § 1 (2010). On this fictional premise, "the corporation, not the people who run it or invest in it, is liable for its contracts and torts." Daniel J.H. Greenwood, Introduction to the Metaphors of Corporate Law, 4 SEATTLE J. SOC. JUST. 273, 290 (2005). Piercing the corporate veil has become "the most litigated issue in corporate law." Marilyn Blumberg Cane & Robert Burnett, Piercing the Corporate Veil in Florida: Defining Improper Conduct, 21 NOVA L. REV. 663, 665 (1997) (citing Robert B. Thompson, Piercing the Corporate Veil: An Empirical Study, 76 CORNELL L. REV. 1036 (1991)).
99. See Stein, supra note 12, at text following n.29.
poses." As such, a series LLC may be a prime target for consolidation.

The LLC statutes of most states hold that the internal affairs and liability of foreign LLC members will be governed by the law of the state where the LLC is organized. Similarly, "the Full Faith and Credit Clause of the U.S. Constitution requires states to respect transactions governed by the law of another state, but not if such law is against the state’s public policy." Yet this is cold comfort because "[a]llowing a defaulting debtor to thumb his or her nose at creditors while holding protected assets is offensive to most disinterested observers" and may run afoul of state policy. More significantly, however, "bankruptcy courts are not bound by state law or by the Full Faith and Credit Clause."

Initially, a "court may be inclined to presume rebuttably that a [series entity] is a separate [and distinct entity with limited liability]." However, a court presented with evidence that "ostensibly separate affiliates have been operated as a single entity" may "create a single pool of assets and a single body of creditors." First, the court will apply a balancing test to determine whether the benefits of substantive consolidation in a particular case will outweigh the harm that might result, utilizing a three-part test:

(1) whether a court should treat the corporation and its counterparts as a single enterprise because the entities blurred their corporate forms;
(2) whether substantive consolidation will remedy the harm caused by the corporation's disregard of corporate separateness for the benefit of the entire creditor body; and
(3) what impact will substantive consolidation have on creditors who relied on the entities' corporate separateness when deciding whether to provide capital.

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102. See CCH Tax Law, supra note 65, at § 3.18.
103. Lin Hanson, Don't Use an LLC for Asset Protection, 96 Ill. B.J. 314 (2008). This author suggests that adequate solutions may be found in the law and in bankruptcy courts.
104. CCH Tax Law, supra note 65, at § 3.18; see also Stein, supra note 12, at 20 ("[A] bankruptcy court would not be bound by the Delaware series LLC statute and could order substantive consolidation.").
105. 15 Collier on Bankruptcy ch. TX13, at n.1 (16th ed. 2010).
106. Id.
After finding that consolidation will, on balance, effect greater good than harm, the court will analyze a host of case-specific facts. Undercapitalization and commingling of assets might be the most classic, weighted factors in a court’s analysis. Yet these factors may not weigh equally on ordinary LLCs and series LLCs. Series LLC statutes require that all “liabilities are compartmentalized between series” in their organizing documents, and further require that assets must be held and accounted for by each series separately. Because this is a condition for the LLC’s limited liability, any commingling “might be interpreted as automatically causing the loss of liability protection.” In this regard, the series LLC has a greater risk profile than regular LLCs because “a single instance of commingling is merely a factor in piercing the veil of a regular LLC and would not automatically cause the assets of one LLC to be subject to the liabilities of a separate, affiliated LLC.” The same instance of commingling might be fatal, however, to the limited liability of a series LLC.

Yet even if a series LLC properly segregates its assets, it may still face substantive consolidation. Other factors relevant to series LLCs include:

- reliance by creditors on the credit of the whole group, reporting operations on consolidated financial statements . . . loan guarantees or other financing between the two entities, transfer of assets without observing transactional formalities, common members, common managers, managers of one entity not acting independently but taking orders from another entity, one entity paying for expenses of the other entity, and one entity referring to the other as a department or division.

One commentator asks whether “the use of a series LLC itself [would be] a factor in showing substantive consolidation.” This is a legitimate question, given that modern substantive consolidation theory has grown from judges’ concern about the increasing use of complex, asset-protection based business structures that may supplant equity. In all likelihood, a court might be more apt to discriminate against a

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109. See Cuff, supra note 41, at 344 (citing Delaware LLC Act Section 18-215(b)).
110. CCH TAX LAW, supra note 65, at § 3.17. See Cuff, supra note 41, at 345 (“It is not clear what happens if a particular asset is used in connection with the business activities of two or more series. This might be a problem where the activities of several series are conducted from a single premises.”) (citing Del. Code Ann. tit 6 § 18-215(b)).
111. CCH TAX LAW, supra note 65, at § 3.17 (emphasis added).
112. See Marsico, supra note 33, at 54-55.
113. Id. at 55.
series LLC on the basis of its status as a series LLC where creditors lacked sufficient notice of the entities’ status as a separate series entity with limited liability. Thus, series LLCs in Illinois might be better protected than those of other states due to the additional name and registration requirements for series entities. Series LLCs organized in other jurisdictions might be well advised to implement the name and registration procedures utilized in Illinois to reduce the plausibility of a creditor’s claim that it lacked notice of the debtor’s series entity status.

The danger of substantive consolidation vis-à-vis the structure of company assets and management can be illustrated with the example of a start-up biotechnology company organized as a series LLC. In an ideal scenario, the series LLC members or managers will possess the business skills and knowledge needed to keep separate financials for each entity and to segregate assets and liabilities, as required by statute. Instead of operating a purely research and development-oriented business model, the company might consider the revenue-funded company model, utilizing series entities to produce revenue streams from outside of the series LLC through research services, “technology flipping,” or manufacturing biological materials. For example, equipment and materials costing less than $10,000 could be placed into a series entity in order to manufacture and sell high value nuclear extracts (proteins removed from cell nuclei). The biggest expense in this scenario is the cost of the researchers’ long hours, yet because researchers in a start-up biotech company are often equity-holders, the operating agreement should be carefully crafted to reflect proportionate interests in both the specific series entity and in the series LLC as a whole. At the theoretical level, then, small start-up biotech companies could utilize series LLCs successfully.

Yet many start-up technology companies have limited resources, “often start[ing] in a garage atmosphere funded by founders, family, and friends.” Thus, it is highly likely that the average technology start-up will be limited in its research facilities, equipment, and other assets. Yet series LLC statutes require that the assets of various series entities be held separately. The degree to which series entities may

utilize other entities' assets is still undefined; however, a court analyzing a scenario where series entities share the same operational facility, equipment, and resources will likely find that the entities commingled assets and forfeited limited liability. Additional financial factors, such as whether the entities shared a cash management system may, in total, incline a court to apply substantial consolidation.

Another important factor to consider relates to the fact that technology start-ups are "usually informally organized with only one level of management and few employees." The informal nature of these start-ups is directly at odds with the level of strict organization, compartmentalization, and bookkeeping that is required to maintain limited liability for a series LLC. A small start-up divided into series entities will likely involve common ownership, management, and workforce, providing support for the application of substantial consolidation. Further, if the series entities are not designed with outside revenue streams and only conduct business with the master LLC, there is probably a greater chance of consolidation. Thus, multiple sources of revenue, reasonably separate assets and management, and a portfolio of diverse business purposes amongst the entities appears to be the golden rule for structuring series LLCs. However, such a portfolio of diverse businesses may be out of reach for most small and medium-sized companies.

B. Single Asset Real Estate Companies in Bankruptcy

Holding real estate is regarded as "[t]he quintessential use of the series LLC." Many practitioners advocate the series LLC structure to segregate real estate parcels and/or on-site businesses into separate series entities, shielding each property or business from liabilities arising from the others. Although such arrangements will save some start-up expenses, it remains an almost un-noteworthy shift from the ongoing practice of isolating separate properties and businesses in dif-

118. CCH Tax Law, supra note 65, at § 3.17. See Cuff, supra note 41, at 345 ("It is not clear what happens if a particular asset is used in connection with the business activities of two or more series. This might be a problem where the activities of several series are conducted from a single premises.") (citing Del. Code Ann. tit 6 § 18-215(b)).


121. Pension Ben. Guar. Corp. v. Ouimet Corp., 711 F.2d 1085, 1092-93 (1st Cir. 1983) (quoting Fish v. East, 114 F.2d 177, 191 (10th Cir. 1940)).

122. See Marsico, supra note 33, at 50.

123. See, e.g., Murray, supra note 46.
ferent LLCs. Unfortunately, using the series LLC in a parallel fashion makes such entities vulnerable to significant disadvantages in bankruptcy, because each LLC or series entity holding only real estate may be considered a SARE.

The first major disadvantage of SAREs in bankruptcy is that "courts often dismiss filings by such entities based on bad faith," even though "such cases are not bad-faith filings per se." Courts look to a number of factors in determining whether to dismiss a SARE bankruptcy, including whether:

1. the debtor has only one asset (the property);
2. the debtor has relatively few unsecured creditors whose claims are small compared to those of secured creditors;
3. the debtor has few employees;
4. the property is the subject of a pending foreclosure and primarily involves a dispute between the debtor and its secured creditor(s); and
5. the debtor's filing was timed to frustrate the legitimate rights and remedies of the secured creditor(s).

This disadvantage is more severe if the primary creditor(s) can buy the claims of small unsecured creditors for greater leverage.

The second major disadvantage of SAREs in bankruptcy is that SAREs get only ninety days to submit a reorganization plan – twenty-five percent less time than allowed for a non-SARE. If the SARE does not submit a plan with a "reasonable possibility of confirmation" within that time, it must make monthly payments to secured creditors at the applicable non-default rate of interest. If it fails to do so, the SARE will be "subject to foreclosure proceedings by their secured creditors after they obtain relief from the automatic stay."

This is unpleasant news in the wake of the global economic downturn precipitated by the sub-prime mortgage crisis, where U.S. home prices quickly fell by nineteen percent, commercial real estate hit

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126. See In re Fighter Ltd., 118 F.3d 635 (9th Cir. 1997), cert denied, 522 U.S. 996 (1997).
record levels of twenty-five percent vacancy in some cities, and where auctioneers handled twice the number of distressed property cases of the previous year in the first four months of 2009. "In the usual SARE case, the debtor . . . [has] an apartment or office building that cannot generate sufficient rental income for the debt service on the mortgage" as a result of "a general decline in the real estate market that [ ]results in a property value . . . lower than the mortgage debt." Amid these conditions, poorly capitalized SAREs may be tremendously disadvantaged, because they have less time to propose a reorganization plan at a time when the value of real estate is severely depressed and distorted. Further, a SARE may find itself making monthly payments to prevent foreclosure on a vacant property generating no revenue.

Large enterprises structured as a multitude of SAREs face compounded problems and greater exposure to systemic risk. If an enterprise holds numerous insolvent SAREs, it will face significant expenses to reorganize each entity. Generally, a company can secure pre-bankruptcy financing to cover the expenses it will face, but interest rates may be fifteen percent and are often loaded with hidden fees along the way. If the company, its constituent SAREs, and its creditors have convoluted relationships that are too complex and unwieldy, a court may apply equitable or substantive consolidation, destroying a company's asset protection scheme.

134. Systemic risk relates to the possibility of a financial system failure that may result through "a series of correlated defaults among financial institutions – typically banks – that occur over a short period of time, often caused by a single major event." Jonathan Sokobin, United States Securities and Exchange Commission, Speech at the APEC Financial Regulators' Training Initiative: Hedge Funds: What Scares Regulators and What Can We Do About it? (Mar. 30, 2007).
136. See Chem. Bank N.Y. Trust Co. v. Kheel, 369 F.2d 845, 847 (2d Cir. 1966) (equitable consolidation is appropriate where "interrelationships of the group are hopelessly obscured and the time and expense necessary even to attempt to unscramble them so substantial as to threaten the realization of any net assets for all the creditors"); see also Jordan A. Kroop, Baseball and the "Abecedarian Prerequisite" to Substantive Consolidation, AM. BANKR. INST. J., Dec.-Jan. 2001, at 22, 22 (substantive consolidation may be used to "avoid the unwieldy (or impossible) task of figuring out which entity owns what, and who owns what to whom"). Courts have also acknowledged that consolidation should be "used sparingly[,]" because the various entities "are likely to have different debt-to-asset ratios, consolidation 'almost invariably redistributes wealth among
C. SARE-Resistant Solutions and Asset Protection Structures for Series LLCs

A series LLC with many series entities holding individual properties might logically anticipate that it can easily merge two series entities that hold real estate in order to avoid SARE status. Further, one would expect that a Delaware Series LLC could quickly deploy this merger on its books, a simple solution requiring no documentation with the state. Unfortunately, this solution will not hold, as the U.S. bankruptcy code's notion of SAREs is not so singular.

Even enterprises holding multiple properties and on-site operations are at risk of being declared a SARE in a bankruptcy proceeding. SARE provisions in the Bankruptcy Code have been amended several times, and earlier versions of the code defined SAREs with an enterprise value ceiling of four million dollars — above that and the company would not be deemed a SARE.\(^{137}\) The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005\(^{138}\) eliminated the enterprise value ceiling for SAREs, and the definition of SARE now broadly includes all properties deemed to be a "single project" when a group of properties have a related connection or purpose in a "common plan or scheme involving their use."\(^{139}\) The enterprise will be considered a SARE if: (1) the debtor has real property constituting a single property or project (other than residential real property with fewer than four residential units); (2) such real property generates substantially all of the gross income of the debtor; and (3) there is no substantial business conducted on the real property other than the business of operating the real property and activities incidental thereto.\(^{140}\) This definition is inclusive of (but not limited to) apartment buildings, office buildings, and strip-mall shopping centers.

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\(^{137}\) See Randy P. Orlik & Susan S. Davis, Single-Asset Real Estate — Congress' Gift to the Secured Creditor, ANDREWS BANKR. LITIG. REP., May 30, 2008, at text accompanying n.2, available at 5 No. 2 ANBKRLR 2 (Westlaw) (citing 11 U.S.C. § 101(51B) (1994), amended by Pub. L. 109-8, § 12041(5)(B) (previously defining a SARE as "[R]eal property constituting a single property or project, other than residential real property with fewer than 4 residential units, which generates substantially all of the gross income of a debtor who is not a family farmer and on which no substantial business is being conducted by a debtor other than the business of operating the real property and activities incidental . . . [with] aggregate noncontingent, liquidated secured debts" not exceeding four million dollars.)).


owned by an entity whose sole purpose is to generate income through the operation of the property and incidental activities relating to the property.\textsuperscript{141}

Even large scale enterprises can be found to be a "single project." A property development company that built homes and condominiums and directly marketed its homes to the public was held to be an SARE in \textit{In re Kara Homes, Inc.}\textsuperscript{142} The court held that the company's revenues would not have been generated but for the eventual sale of the real estate, and thus, the building activity and marketing were intrinsic and incidental to operating or developing the property.\textsuperscript{143}

However, cases like \textit{In re Whispering Pines Estate, Inc.} provide that some businesses conduct activities that are sufficiently distinct from the incidental operation of the property (hotels, for example) and these operational activities preclude SARE status.\textsuperscript{144} Similarly, most country clubs would probably not be SAREs, because they have multiple revenue-generating activities, including membership sales, golf course fees, golf cart rentals, tennis court fees, food and alcohol sales at country club restaurants, merchandise sales at golf pro shops, and space rental for special events.\textsuperscript{145}

The hotel and country club cases provide two important insights. First, a company may avoid SARE status with diversified business activities that generate revenues distinct from the management of the property. Second, many small and medium-sized companies may not have the economies of scale or resources to "tranche" their operations with diverse revenue streams; some of them will only have revenue incidental to operating properties, and thus, it may be more difficult to structure SARE-resistant solutions for them. Yet, a recent case, \textit{In re Scotia Dev., LLC},\textsuperscript{146} provides hope that some businesses may be able to escape SARE classification through smaller-scale business activities on the property.

\textit{In re Scotia Dev., LLC} involved a company holding rights to harvest and sell 200,000 acres of timberland.\textsuperscript{147} While the court did spend

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\textsuperscript{141} \textit{In re Syed}, 238 B.R. 133 (Bankr. N.D. Ill. 1999); \textit{see also In re KKEMKO}, 181 Bankr. 47, 50 (holding that apartment buildings may constitute an SARE).
\textsuperscript{142} \textit{In re Kara Homes, Inc.}, 363 B.R. 399, 406 (Bankr. D.N.J. 2007).
\textsuperscript{143} \textit{Id.}
\textsuperscript{144} 341 B.R. 134, 136 (Bankr. D.N.H. 2006); \textit{see also In re CBJ Devel., Inc.}, 202 B.R. 467, 472 n.7 (B.A.P. 9th Cir. 1996) (a hotel may be an SARE depending on services provided and the number of people it employs).
\textsuperscript{145} \textit{In re Club Golf Partners, L.P.}, No. 07-40096, 2007 WL 1176010, at *6 (E.D. Tex. 2007).
\textsuperscript{146} \textit{In re Scotia Dev., LLC}, 375 B.R. 764 (Bankr. S.D. Tex. 2007), aff'd, 508 F.3d 214 (5th Cir. 2007).
\textsuperscript{147} \textit{Id.} at 766.
\end{footnotesize}
time addressing the size of the enterprise and its numerous employees, perhaps the most significant portion of the judgment held, "[w]here a debtor is actively using property in its operations any revenue generated is attributable to the operation and not the property." This case confirms the possibility that farmers organized as series LLCs (and otherwise following all proper procedures and formalities) could successfully avoid SARE status. Series entities could be used to segregate farm real estate from some operational aspects of the farm for asset protection purposes. However, to guard against SARE status risk in bankruptcy, it may be advisable to leave some of the revenue-generating operations of the farm unsevered from the segregated real estate parcels. A farmer might also have to invest in additional (potentially duplicate) equipment for use with the different series entities. Cuff provides an example where a farmer with very large holdings organizes into multiple entities, and the principle behind In re Scotia Dev., LLC would seem to hold for farmers on a smaller enterprise value scale, too, to the extent of their ability to invest capital, resources, and management into separate entities.

Restaurants are similarly unlikely SARE candidates when the company owns the real estate and the operational arm of the restaurant. Arguably, there is only one main revenue-generating activity – providing food and service to customers – an activity that is not oriented around the sale or lease of property or incidental activities relating to the sale or lease of land. In re Scotia Dev., LLC provides support for such an argument, holding that “a debtor is not a single asset real estate debtor where . . . revenue is the product of the efforts of management and workers conducted on the lands, bringing in the customers and selling services and goods to them.” For this reason, a restaurant may be structured with some of its operations paired with the real estate to prevent SARE risk. But some restaurants might still be able to segregate operations. If the restaurant provides off-site catering services, for example, catering and on-site restaurant operations could be segregated in separate series entities and paired with real property as desired.

149. See Cuff, supra note 41, at 348-49.
Restaurants that wish to segregate certain operations, such as catering, from the main operation of the restaurant face similar challenges as those discussed in relation to start-up technology companies. Restaurants will be naturally inclined to use the same systems and resources for both on-site operations and off-site catering operations. However, to create a secure series entity that has less risk of substantive consolidation, the segregated operations should use separate point-of-sale systems, have separate employment agreements with catering company employees, differentiate the brand names and promotional materials of the two services, and avoid comingling property. Some of my clients have even built an additional kitchen onto their restaurants to address this kind of issue and to accommodate the growth of their catering businesses. Clearly, a restaurant must make a significant investment to establish independent, segregated series entities that that will stand up in court.

While some businesses such as hotels, country clubs, farms, and even restaurants often have sufficient resources to tranche operations and property effectively, they also have a specific SARE-resistant advantage under In re Scotia Dev., LLC, because the nature of these businesses involves the sale of goods and services. But what kind of solutions are available for businesses with real estate holdings that do not produce revenue by goods and services, but merely through incidental operation of the property? For most small and medium-sized businesses, a fully satisfactory solution may be out of reach, because these business will generally lack the capital, assets, workforce, and management required to organize a master series LLC with diverse business activities segregated into functioning series entities.

Larger organizations, on the other hand, are in a much better position to extract and restructure business operations, especially frequently outsourced services. For example, billing and collection services that are handled separately by each series entity could be consolidated into a new series entity. Similar arrangements could be made with property management and maintenance activities, marketing activities, equipment rental and maintenance, insurance brokering, or purchase management for commodities, energy, or other utilities. To protect the series entity and the series LLC from the potential risk of equitable consolidation, however, a service-oriented series entity should seek revenue streams outside of the series LLC and hold itself out to the public as open for business.

By effectively “tranching” various operations, a company may combine them with real estate or keep them separate to meet its desired operational, capital, and risk structure objectives in a portfolio of se-
ries entities. Members of the series LLC can structure their master LLC allocations with varying interests in the network of series entities, allowing investors to achieve an individually structured risk and investment profile within the company.

In addition to isolating risk and generating independent streams of income, the segregated service and goods companies are also valuable as potential merger candidates when series entities holding real estate face solvency problems. A merger would have no tax impact on the master LLC because both entities (if properly formed) can elect to be disregarded under the Check the Box Regulations.\textsuperscript{151} Prior to the merger, the two entities may have varying profit and loss allocations designated to different master LLC members, and the merger will require an amendment to the operating agreement, which can be achieved without the recognition of tax gain or loss.\textsuperscript{152} Yet series LLCs should take extra care to ensure proper execution and to ensure that the transaction does not constitute a fraudulent transfer,\textsuperscript{153} which, among other things, requires arms-length transactions at a fair value. Such transactions may require additional injections of capital, perhaps from other series LLC members or from new investors. The series LLC is perfectly designed to allow a new investor to step in and revitalize an insolvent company. The new investor makes a contribution and can receive an allocation to a percentage of profits from one or more existing series entities, or form a new series entity created and merged with other series entities.

Clearly, the series LLC potentiates many innovative solutions for risk structuring, asset protection, business reorganization, and organic business growth. The biggest challenge is that a company cannot take shortcuts when using this vehicle – otherwise, it risks forfeiting everything it attempted to structure. Smaller companies often lack the capital, assets, and management necessary to operate a network of series entities that can withstand substantive consolidation and/or SARE status in bankruptcy. Larger enterprises, however, may implement economies of scale and management that truly unlock the series LLC’s potential as a business and investment vehicle.

\textsuperscript{151}See supra notes 66-75 and accompanying text.


\textsuperscript{153}But special care should be taken that the transaction would not constitute an avoidable, fraudulent transfer. See 11 U.S.C. §§ 548, 550 (2006).
V. Conclusion

The series LLC is not a panacea structure that will work for all business enterprises. Enthusiastic calls to “roll out” the series LLC for small and medium-sized businesses are not only “premature”; they may also be imprudent. Indeed, even the quintessential use of series LLCs – holding real estate in segregated entities – appears to suffer from tremendous downside risk and bankruptcy disadvantages. The lack of adequate assets, management, and workforce is also a major impediment to structuring effective series LLCs for small businesses. Further, the series LLC’s strict statutory requirements on segregating assets and liabilities may be a trap for unsophisticated members, who may blunder and destroy the series LLC’s limited liability.

Larger, more sophisticated operations, on the other hand, could utilize this vehicle effectively, taking instruction from Private Letter Ruling 20-08-030-04 and growing diverse business operations organically in series entities that are segregated or paired with real estate to meet a company’s desired operational, capital, and risk structure objectives. Additional developments in tax and bankruptcy law could heighten the series LLC’s performance as an advantaged vehicle for investment and innovation. In the area of tax, safe harbor provisions could disregard multi-member series entities where common ownership, enterprise value, and other factors meet specified requirements. In bankruptcy, re-establishing an asset-value ceiling for SARE status would improve the risk profile for all companies holding real estate of significant value, especially series LLCs holding properties in segregated series entities; it would also ease pressure on real estate markets during periods of volatility and extended economic downturns.

154. CCH Tax Law, supra note 65, at § 3.25.