SERIES LLCS:
NUTS AND BOLTS, BENEFITS AND RISKS, AND THE UNCERTAINTIES THAT REMAIN

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TABLE OF CONTENTS

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I. INTRODUCTION

A. Definition of a Series LLC

A series limited liability company ("**Series LLC**") is a variation of the traditional limited liability company ("**Traditional LLC**") that is available under several states' limited liability company ("**LLC**") statutes. A Series LLC is, effectively, a collection of subunits within one LLC that can be created according to statute without actually forming multiple LLCs. Under a typical Series LLC statute, found in Delaware, Texas, Illinois, and several other states, a Series LLC can have as many different, individual series as the members desire, and each series looks and acts almost exactly like a separate LLC. In effect, a Series LLC is a way around creating multiple LLCs – only a single entity need be created, but assets, ownership and, therefore, liability, can be allocated exactly as if multiple entities had been formed.

A Series LLC begins with the formation of an LLC, which, for the sake of clarity, will be referred to in this article as the "**Umbrella LLC**." The Umbrella LLC may, provided it meets certain statutory requirements discussed below, form one or more series within itself (although most statutes use the term "series" for an individual cell under an Umbrella LLC, for clarity this article refers to a "**Subunit**"). In spite of the fact that they are contained within a single Umbrella LLC, each Subunit behaves like a separate LLC. A Subunit may have its own assets, its own liabilities and its own owners, which need not resemble the assets, liabilities or ownership of the Umbrella LLC. A Subunit can, just like a Traditional LLC, enter into contracts in its own name, sue or be sued, and hold title to assets in its own name. And, just like a Traditional LLC, each Subunit within a Series LLC is shielded from the liabilities of the other Subunits.

The liability limitation is the most important feature of a Series LLC. As long as one complies with the requirements of the statute, only the assets of a given Subunit are available to satisfy the liabilities of that Subunit. And not only is each Subunit shielded from the liabilities of each other Subunit, but the Umbrella LLC is likewise shielded from the liabilities of each of its Subunits. Furthermore, it makes no difference for liability purposes whether a Subunit shares common ownership with another Subunit or the Umbrella LLC or whether none of the Umbrella LLC members is an owner of such Subunit.

B. History of the Series LLC

The Series LLC first arose with the passage of the Delaware LLC statute in 1996. The concept of a series-type entity, though, was not novel at the time. The idea of a series entity existed in Delaware and other jurisdictions in the arena of investment companies, statutory trusts and asset securitization.[1] For investment companies, series can be created as "administrative subunits" that allow a single company to partition assets without creating multiple legal entities, thus simplifying SEC filings and other administrative requirements.[2] In the context of statutory trusts, a single trustee can allocate assets into different series without the burden of creating multiple trusts. Similarly, in the asset securitization field, multiple series securities backed by different assets can be issued by a single entity with less administrative difficulty than it would require to create multiple entities.

[1] DEL. CODE ANN. tit. 12, § 3804 (2006); Thomas E. Rutledge, *Again, For Want of a Theory: The Challenge of the "Series" to Business Organization Law*, 46 AM. BUS. L.J. 311, 313 (2009).

[2] *Id.*

The series concept has matured outside of the United States, as well, in the form of segregated portfolio companies. In tax havens like Guernsey, the Caymans, and the British Virgin Islands, companies can be formed with multiple portfolios or cells, each of which is protected from the liabilities of the others. Segregated portfolio companies, also known as captive cell companies, are used extensively in the fields of captive insurance[3] and also as investment companies.[4]

The Delaware Series LLC statute took the general concept of series creation, as seen in investment companies, asset securitization, and segregated portfolio companies, and adapted it to the LLC form. Since Delaware adopted its statute in 1996, 10 additional jurisdictions have made provisions for Series LLCs in their LLC statutes.[5]

C. Laws Authorizing Series LLCs

While the various Series LLC authorization statutes have the same general aims, there are some key differences among them. The few states that have a Series LLC statute generally follow either the Illinois-style statute or the Delaware-style statute. The primary difference between the two is their characterization of the legal status of an individual Subunit. The Delaware statute gives each Subunit many of the powers and rights of separate legal entities, but does not explicitly recognize each Subunit as such.[6] The Illinois system explicitly grants each Subunit separate legal entity status.[7] The difference is further emphasized by the filing requirements of the two states. Delaware simply requires that the Umbrella LLC file a certificate of formation disclosing the limitation of liability of any Subunit that has been or might be created.[8] There are no requirements that the Umbrella LLC file any document with the state upon the creation of a new Subunit. By contrast, Illinois requires that a separate certificate of designation be filed by the Umbrella LLC for each Subunit created.[9] Further, the certificate of the Subunit in Illinois must identify the members and managers of a Subunit if different than the members and managers of the parent.[10] Most states, including Texas, follow the Delaware model for their Series LLC statutes.

D. The Appeal of Series LLCs

Features like liability shielding and distinct asset ownership have long been possible through the creation of separate LLCs. And, practically speaking, the benefits of Series LLCs are not groundbreaking. But conceptually, the Series LLC is a useful simplification, a way to ease the burden and cost of creating layers of numerous entities. Rather than having to prepare multiple sets of formation documents and pay the fees to form multiple entities, a single Series LLC would suffice. Furthermore, Series LLCs provide flexibility to members of the Umbrella

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[3] HANDBOOK OF INT'L INS. 935 (J. David Cummins & Bertrand Venard eds., 2007).

[4] Sandra Mertens, Series Limited Liability Companies: A Possible Solution to Multiple LLCs, 84 CHI.-KENT L. REV. 300 (2009).

[5] The following jurisdictions have a series LLC statute: Delaware, Illinois, Iowa, Kansas, Nevada, Oklahoma, Puerto Rico, Tennessee, Texas, Utah, and Wisconsin.

[6] DEL. CODE ANN. tit. 6, § 18–215(c) (2010).

[7] 805 ILL. COMP. STAT. 180/37–40(b) (2010).

[8] DEL. CODE ANN. tit. 6, § 18–215.

[9] 805 ILL. COMP. STAT. 180/37–40.

[10] *Id*.

LLC to decide how to allocate assets and liabilities without having to create new entities.[11] Ideally, the Series LLC looks like a cheaper, easier way to structure a business.

And were it not for the numerous issues and problems discussed below, the Series LLC could in practice be just that. In fields like real estate where a single-asset entity makes both legal and business sense, Series LLCs could be widely implemented. The administrative simplicity and cost savings could also appeal to specially regulated businesses that want to avoid having to pay additional fees and face various regulatory waiting periods.[12]

But several problems and questions surround Series LLCs that have, in the 16 years since the enactment of the Delaware statute, kept them out of mainstream use.[13] There is little hard evidence to help practitioners know how a Series LLC formed in a state like Texas would be treated in state without a Series LLC statute. Also, significant questions in the areas of taxation, bankruptcy, and securities law, combined with a general dearth of case law, make the consequences of establishing a Series LLC too uncertain to be worth the small administrative and cost savings over forming multiple entities.

E. Article Overview

Because of the lack of certainty surrounding Series LLCs as noted above, there is little practical experience from which to glean concrete advice for practitioners. However, in September 2010 the Internal Revenue Service ("**IRS**") issued Proposed Regulations which help resolve what was previously one of the biggest unknowns: tax treatment of Series LLCs. We believe that the potential benefits of utilizing Series LLCs, combined with such additional guidance, will lead to more use of Series LLCs. Here, we offer an overview of the requirements for forming and maintaining Texas Series LLCs, risks and potential uses for Series LLCs, and a discussion of federal and state tax treatment and bankruptcy issues.

II. FORMATION, GOVERNANCE, AND STRUCTURE

The Texas Business Organizations Code ("**TBOC**") contains the formation and governance requirements for Series LLCs created in Texas. This statute provides that an LLC may establish "one or more designated series of members, managers, membership interests, or assets" in its company agreement.[14] These Subunits may engage in separate business activities and may carry on any lawful business allowed under the TBOC.[15] This is the informal process by which a Traditional LLC becomes a Series LLC. While there is no statutory requirement that each Subunit in a Series LLC must have its own operating agreement, such an arrangement might be preferable, particularly in an LLC with a complex governance structure. Because each Subunit of a Series LLC enjoys separate liability from other Subunits and from the Umbrella LLC, the Texas statute requires the Umbrella LLC to provide a notice of these liability limitations in its certificate of formation.[16]

The Texas statute mandates that LLCs utilizing separate Subunits follow certain business practices in order to maintain separate Subunit liability. First, the records for each Subunit must account for that Subunit's assets separately from the assets of the Umbrella LLC

[11] Wendell Gingerich, *Series LLCs: the Problem of the Chicken and the Egg*, 4 ENTREPRENEURIAL BUS. L.J. 185, 187 (2009).

[12] Vicki R. Harding, *Series LLCs: A Wave of the Future – Or Not?*, 1 MICH. BUS. L.J. 19, 22 (2007).

[13] Mertens, *supra* note 4, at 309–10.

[14] TEX. BUS. ORGS. CODE ANN. § 101.601(a) (West 2011).

[15] *Id.* § 101.601(a)(2), (b).

[16] *Id.* § 101.602(b)(3).

or any other Subunit.[17] However, the assets of a Subunit may be held either directly or indirectly, "including being held in the name of the series, in the name of the limited liability company, through a nominee, or otherwise."[18] Second, the company agreement of the Umbrella LLC must contain a statement providing for the separate liability of each Subunit; namely, that the debts, liabilities, obligations, and expenses of a Subunit are enforceable against the assets of that Subunit only.[19] Third, as mentioned above, the Umbrella LLC must provide notice of these Subunit liability limitations in its certificate of formation.[20] However, an Umbrella LLC need not have any Subunit already established at the time this notice of limitations is included in the certificate of formation, and, once the notice is included, it is not required to make reference to any particular Subunit.[21] Because of this, a general notice of separate Subunit liability may be included in the Umbrella LLC certificate of formation at the outset, giving the Umbrella LLC the flexibility to create Subunits in the future without amending its certificate.[22]

In contrast to these mandated formation provisions for maintaining separate Subunit liability, the TBOC provides a flexible scheme for Series LLC governance. As with Traditional LLCs, the company agreement can create a wide array of governing powers, duties, and controls. The company agreement can establish groups of managers or members to be associated with a particular Subunit; it can create the process to be used for establishing additional groups of managers or members; and it can provide the voting rights of various members, managers, or groups thereof.[23] Additionally, the company agreement can establish a record date for distributions with respect to a particular Subunit.[24] Hence, the members or managers of a Series LLC have wide latitude for creating a customized governance structure in the company agreement.

Texas law applies flexible statutory provisions to Series LLCs that encourage both compartmentalized liability as well as entity perpetuation. For instance, an event under the company agreement that causes a member of a particular Subunit to no longer qualify as a member of that Subunit does not, in and of itself, revoke membership status in the Umbrella LLC or in any other Subunit.[25] The same holds true for managers.[26] Therefore, members or managers may be associated with various Subunits of an Umbrella LLC, but their roles are treated as mutually exclusive unless otherwise specified in the company agreement. These provisions prevent administrative and managerial hiccups in one Subunit from spilling into additional Subunits or the Umbrella LLC as a whole.

Similar protections are applied to winding up and termination. The Umbrella LLC must provide notice of the termination of any Subunit pursuant to the requirements, if any, in

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[17] *Id.* § 101.602(b)(1). These records should be maintained "in a manner so that the assets of the series can be reasonably identified by specific listing, category, type, quantity, or computational or allocational formula or procedure, including a percentage or share of any assets, or by any other method in which the identity of the assets can be objectively determined." *Id*. § 101.603(b).

[18] *Id*. § 101.603(a).

[19] *Id.* § 101.602(a), (b)(2).

[20] *Id.* § 101.602(b)(3).

[21] *Id.* § 101.604.

[22] 19 Robert W. Hamilton, Elizabeth S. Miller & Robert A. Ragazzo, TEX. PRACTICE BUS. ORGS. § 19:35 (3d ed. 2012).

[23] *See* TEX. BUS. ORGS. CODE ANN. § 101.607 (West 2011).

[24] *Id.* § 101.612.

[25] TEX. BUS. ORGS. CODE ANN. § 101.610(b) (West 2011). In fact, even if the last remaining member of a series ceases to be a member, this alone does not require the winding up of the series. *Id*. § 101.610(b).

[26] *Id*. § 101.610(a).

the company agreement.[27] Yet, entity continuity is ensured by the fact that the winding up and termination of one Subunit does not cause the winding up of any other Subunit or the Umbrella LLC; nor does the winding up of a Subunit affect the separate liability enjoyed by that Subunit.[28] Naturally, however, the winding up of the Umbrella LLC requires the winding up of all Subunits contained within the Umbrella LLC.[29]

III. RISKS AND POTENTIAL USES

A. Hazards of a Series LLC

At first glance, it seems clear that the Texas Legislature intended to keep separate the liabilities of each Subunit in a Texas Series LLC: "the debts, liabilities, obligations, and expenses incurred, contracted for, or otherwise existing with respect to a particular series shall be enforceable against the assets of that series only, and shall not be enforceable against the assets of the limited liability company generally or any other series."[30] While it appears the language is clear, it is important to note that in order to be treated in such a way, each Subunit must meet a number of formal requirements.[31] Most importantly, the records that are maintained for a particular Subunit must only account for assets of that Subunit and keep separate all other assets of the company or any other Subunit.[32]

While this may not seem that difficult in theory, it may be more unrealistic to implement in practice. The standard for complying with maintaining Subunit records separately does not appear to be altogether cumbersome;[33] however, it is important to remember that one reason Traditional LLCs are so widely used is because very few formalities are required of them.[34] Thus, any requirements to keep separate records for different Subunits in a Series LLC is an added step that is not required when operating under a Traditional LLC.

Although keeping separate records is not a huge obligation, it is essential because debts and liabilities will not be treated as belonging to a separate entity if these formalities are not precisely met. Therefore, the risks may outweigh the benefits in this regard, as a company may be operating under the impression that liabilities of a particular Subunit belong to that Subunit alone, when in reality it may only take a slight record-keeping oversight to allow the liabilities to attach to the entire Umbrella LLC and the other Subunits.

This would prove especially disastrous in the case of a particular Subunit engaging in risky behavior. For example, imagine a large Texas company, Conglomerate, LLC, which is involved in a number of different industries, with different parts of the Umbrella LLC being organized into various Subunits. One such Subunit is involved in transporting hazardous waste materials to the proper disposal sites. If each truck transporting the waste, or even the entire transporting division itself, was organized as a separate Subunit of Conglomerate, the

[27] *Id.* § 101.615(b).

[28] *Id.* § 101.614, .615(c).

[29] *Id.* § 101.616(1).

[30] *Id.* § 101.602(a)(1).

[31] *Id.* § 101.602(b).

[32] *Id.* § 101.602(b)(1).

[33] "If the records of a series are maintained in a manner so that the assets of the series can be reasonably identified by specific listing, category, type, quantity, or computational or allocational formula or procedure, including a percentage or share of any assets, or by any other method in which the identity of the assets can be objectively determined, the records are considered [separately maintained according to] the requirements of Section 101.602(b)(1)." *Id.* § 101.603(b).

[34] *See generally id.* §§ 101.051-101.054.

intent would be for that Subunit to have liabilities separate from the Umbrella LLC and other Subunits. Thus, in the event of a catastrophic accident or spill of the hazardous material, the general assets of Conglomerate and the assets of the other Subunits would be protected from liability; however, if all the records of Conglomerate were maintained together and could not be reasonably identified as belonging to a particular Subunit, then the Subunit would lose this protection and liability that Conglomerate thought it was protecting against would instead be a liability of the entire Series LLC.

In a similar vein, Series LLCs may be risky because of the uncertainty of how they will be treated in bankruptcy and tax contexts. While both of these issues have different implications, it appears that they both may hinge on whether the series is treated as a separate legal entity. A serious issue is what happens when a single series in a Series LLC declares bankruptcy. For example, if the Conglomerate series involved in the shipping of hazardous waste materials declares bankruptcy because the liabilities from the spill have become too great for the series to bear, what effect does this have? While this may be somewhat clearer in jurisdictions where the statute specifies the series is a separate legal entity, such as in Illinois,[35] there is no such provision in the Texas Series LLC statute. If Texas does not treat each series as a separate legal entity, then this poses the potential risk that if one series becomes involved in bankruptcy proceedings, it could endanger all of the Conglomerate's assets. A more in-depth discussion of the tax and bankruptcy issues follows this section.

Another hazard of Series LLCs is the fact that they are still relatively new and are only recognized in a minority of states. If Series LLCs become more popular and begin conducting business in a state with a similar Series LLC statute (such as a Delaware series doing business in Texas), it is easier to see how that particular state would treat the Subunits. However, what happens when a Series LLC begins operating in a foreign jurisdiction without a Series LLC statute? Choice of law provisions may apply so that the foreign jurisdiction has to recognize the laws where the company is organized, but it is unclear what happens if the foreign jurisdiction is not forced to recognize an entity as a separate Subunit.

This uncertainty would undoubtedly cause concern for a company thinking about organizing as a Series LLC because if it plans on conducting business outside of Texas (save for, perhaps, in states with Series LLC statutes similar to Texas's), the company has no indication of how any foreign jurisdiction would treat the Subunit – indeed, it may well vary from jurisdiction to jurisdiction. Borrowing from the example above, if Conglomerate conducts business in a state that has not adopted Series LLCs, it could expose the entire company's assets to liability for a hazardous waste spill, even if it observes all the corporate formalities and properly keeps the records of the different Subunits separate. With this doubt, it might make more sense for a company to form multiple LLCs in similar instances rather than exposing itself to uncertain liability by forming Series LLCs.

Series LLCs also may be more susceptible to courts piercing the corporate veil. Courts have been willing to ignore the limitation on corporate liability "when the corporate form has been used as part of a basically unfair device to achieve an inequitable result."[36] Courts will sometimes pierce the corporate veil when owners of a company fail to treat it as a distinct legal entity or fail to observe the corporate formalities. A company is especially susceptible to piercing when the court finds the company is the mere alter ego of the owners.

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[35] *See* 805 ILL. COMP. STAT. 180/37–40(b) (2010).

[36] SSP Partners v. Gladstrong Invs. (USA) Corp., 275 S.W.3d 444, 451 (Tex. 2008) (quoting Castleberry v. Branscum, 721 S.W.2d 270, 271 (Tex. 1986)).

This biggest problem of Series LLCs relating to piercing the corporate veil is the same recurring problem: the uncertainty associated with how Series LLCs will be treated. While Series LLCs may be afforded similar protection as Traditional LLCs, they may also be treated like a close corporation and be more susceptible to piercing. This could become even more likely and problematic if, as discussed above, the owners fail to keep separate records for each of the Subunits. In this context, a court could potentially decide the owners were failing to observe the corporate formalities and would pierce the corporate veil to go after the owners personally.

The above discussion relates to potential problems for the owners of a Series LLC; however, a Series LLC could have unfair effects on those dealing with the Series LLC, namely its creditors. Creditors that are dealing with an LLC will generally know that the company has some sort of limited liability protection. There is a great risk, though, that a creditor of a Series LLC will have no idea the company is a Subunit. All that is required to give notice of limitation on liabilities of a Subunit is notice contained in the certificate of formation.[37] Furthermore, a blanket notice of the Subunits can be given, as the notice does not have to refer to a specific Subunit,[38] and a Subunit does not even have to be established when the notice in the certificate of formation is given.[39]

Thus, it is very likely that a potential creditor of a Series LLC would have no idea there was a Subunit. This could cause a creditor to lend more money to a Subunit than it probably should because of the mistaken notion that it has all of the assets of the entire LLC to back the loan. This is especially hazardous to potential creditors because there is no requirement that the name of the Subunit be distinguishable from the Umbrella LLC as a whole. Therefore, unless the creditor actually looks to the certificate of formation filed with the secretary of the state, it is very likely that the creditor will believe it is dealing with a Traditional LLC rather than a Subunit in a Series LLC.

Although some of the hazards discussed above are more likely than others, there is one recurring theme: due to Series LLCs being relatively new and to so few states utilizing them, there is a lot of uncertainty as to the risks involved. While Series LLCs do provide a number of benefits, it is important to be cognizant of the risks and potential risks associated with forming a Series LLC.

B. Potential Uses of a Series LLC

Although there are a number of potential risks one may encounter in forming a Series LLC, there are a number of beneficial ways in which they may be used. The most obvious benefit of the Series LLC is allowing owners of an LLC to limit the liabilities of certain assets or activities within the company. However, they can also be quite useful for companies with multiple assets, diversified activities, or multistate operations.

A Series LLC may be quite useful for companies with multiple assets. The example often given pertains to taxi cabs and cab drivers. When a cab company owns a number of taxi cabs, it is important to have some limited liability so that if one cab driver gets into an accident, it does not jeopardize the personal assets of the owner. However, in order to protect the assets of the entire corporation or LLC, an owner would have to set up multiple corporations or LLCs for each cab or at least for a small number of cabs. With a Series LLC,

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[37] TEX. BUS. ORGS. CODE ANN. § 101.604 (West 2011).
[38] *Id.* § 101.604(2).
[39] *Id.* § 101.604(1).

however, a cab company can own hundreds of cabs and set up a distinct Subunit for each cab, thereby limiting any liability incurred by that cab to that Subunit alone.

Another area with multiple assets where this would be useful is when a company or owner owns a number of real estate projects. Typically, LLCs or corporations are set up for different real estate ventures for the same reason – to limit liability to that project alone. By utilizing a Series LLC, however, a company can maintain this same limited protection by establishing a different Subunit for each real estate project, and thereby limiting any risk to that project if the project never gets completed, becomes insolvent or needs to be foreclosed, or if there is some accident on the premises.

While companies are still able to enjoy many of these benefits currently under Traditional LLCs or corporations, the benefit of forming a number of different Subunits is that it appears to be a more simplistic approach. The benefit of a Series LLC is the simplicity of having a single business entity controlling all of these assets, rather than an interconnected web of numerous different LLCs each controlling a separate asset, in addition to any cost reduction in setting up a Subunit as opposed to an entirely new LLC.

Much in the same way, a company with diversified activities could do well to use a Series LLC to limit the liability of each different activity. In the example above pertaining to Conglomerate, LLC, Conglomerate would be wise to segregate its different activities into distinct Subunits. This would allow Conglomerate to operate as one company overseeing all of its different divisions, yet it would still provide the protection of limiting the liability of each division.

Furthermore, a business entity that provides professional services in a number of different jurisdictions would be wise to set up a Series LLC. While this would obviously be affected by which jurisdictions either allow for Series LLCs or would at least acknowledge them, an enterprise could effectively set up a different Subunit for each state it does business in, thereby limiting malpractice to the states where the activity took place. For example, a national hospital chain could create a different Subunit for each state it has a hospital in and thereby limit malpractice claims against a doctor in Texas to Texas alone and not encumber the entire organization.

These are just a few potential uses for a Series LLC. Anytime there is a business that either has a number of assets or operations and wants to limit liabilities to each particular asset or operation, it is important to consider whether a Series LLC would be appropriate to use and whether it could accomplish the same goals with more ease.

IV. TAXES

A. Federal Tax Issues

Until recently, the IRS has offered relatively little supervision as to the correct tax treatment for Series LLCs. In fact, that is likely one of the primary reasons that Series LLCs have not been used more frequently. In order to provide some clarification for taxpayers looking to utilize the Series LLC entity structure, on September 14, 2010, the IRS issued Proposed Regulation § 301.7701-1(a)(5) (the "**Proposed Regulation**") to offer some guidance as to how Series LLCs should be treated for federal tax purposes. Specifically, the Proposed Regulation recognizes each individual Subunit in a series organization (for our purposes, the

Series LLC)[40] as an entity for federal tax purposes, lays out rules for how it will treat the ownership of each Subunit in a Series LLC, and establishes a transition rule for existing Series LLCs that have previously filed tax returns differently from how the regulation will require going forward, assuming it is adopted. Therefore, while it has not answered every question with respect to Series LLCs,[41] the Proposed Regulation has largely clarified the IRS's position with respect to these entities, and likely enhances their attractiveness as a business entity by providing taxpayers with some security as to how they will be treated from a federal tax standpoint.

The most significant function of the Proposed Regulation is to recognize each Subunit in a Series LLC as an entity for federal tax purposes. Specifically, the Proposed Regulation holds that each Subunit established under a series statute will be treated as an entity for federal tax purposes, regardless of whether the Subunit meets the requirements necessary to qualify as a formal entity under state law.[42] The Proposed Regulation defines a "series statute" as a state statute that provides for the organization of a series, and explicitly permits members of the Series LLC to have "rights, powers, or duties with respect to the series," for each Subunit in the organization to have "separate rights, powers, or duties with respect to specified property or obligations," and "the segregation of assets and liabilities such that none of the debts and liabilities of the series organization…or of any other series of the series organization are enforceable against the assets of a particular series in the organization."[43] The Proposed Regulation defines a series (here, a Subunit) as "a segregated group of assets and liabilities that is established pursuant to a series statute…by agreement of a series organization."[44] Finally, the Proposed Regulation also holds that being established as an entity under a state statute is insufficient; the entity must also meet standard requirements such as a business purpose and a business activity other than tax avoidance in order to qualify as an entity for federal purposes.[45]

Also significant, the Proposed Regulation lays out guidelines for how taxpayers should treat the ownership of each Subunit in a Series LLC. The Proposed Regulation specifies that the ownership of the interests of an individual Subunit, and ownership of the assets associated with an individual Subunit, will be determined under "general tax principles," and that the Series LLC will not necessarily be treated for federal tax purposes as the owner of a Subunit, or of the assets associated with that Subunit, merely because it holds legal title to those assets.[46] While the Proposed Regulation does not specify how a "general tax principles" analysis should proceed, the Preamble to the Proposed Regulation suggests that in order to assess the ownership of a Subunit, an analysis under general tax principles will look to determine which parties receive the economic benefits and bear the economic burdens of ownership, and may also look to any common-law principles that may apply.[47]

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[40] Though this discussion is limited to Series LLCs, the Proposed Regulation also applies to series partnerships, series trusts, protected cell companies, segregated cell companies, segregated portfolio companies, and segregated account companies. Prop. Treas. Reg. § 301.7701-1(a)(5)(viii)(A), 75 Fed. Reg. 55699, 55708 (Sept. 14, 2010). The Proposed Regulation also discusses entities formed under foreign statutes and series organizations conducting insurance business, both of which are also outside the parameters of this discussion. *See id.* § 301.7701-1(a)(5).

[41] Specifically, the Proposed Regulation does not address, and the IRS requests comments on, several issues including potential options for employment tax issues (both federal and state) and employee benefits issues with respect to individual series. *See* Preamble to Prop. Treas. Reg. § 301.7701-1(a)(5), 75 Fed. Reg. 55699, 55704 (Sept. 14, 2010).

[42] Prop. Treas. Reg. § 301.7701-1(a)(5)(i).

[43] *Id.* § 301.7701-1(a)(5)(viii)(B).

[44] *Id.* § 301.7701-1(a)(5)(viii)(C).

[45] *Id.* § 301.7701-1(a)(5).

[46] *Id.* § 301.7701-1(a)(5)(vi).

[47] Preamble to Prop. Treas. Reg. 301.7701-1(a)(5).

In addition to providing a means by which to evaluate Subunit ownership, the Proposed Regulation also establishes the type of entity that each individual Subunit will be for federal tax purposes, and therefore establishes the process for determining the tax return filing responsibilities for each individual Subunit. It does so by providing that once a Subunit is determined to be an entity for federal tax purposes (as explained above), that the evaluation as to what type of entity it will be for federal purposes will fall under a standard analysis through Treasury Regulations 301.7701-2 through 301.7701-4.[48] Essentially, unless a Subunit specifically elects to check the box and treat itself as a corporation, a Subunit with one owner will be treated as a disregarded entity for tax purposes, and a Subunit with multiple owners will be treated as a partnership. To provide additional guidance, the Proposed Regulation offers an example to demonstrate how Subunit ownership should be treated. In the example, a Series LLC properly formed under a series statute has three members (1, 2, and 3), and establishes two Subunits (Series A and B). Under a general tax principles analysis, Members 1 and 2 own Series A, and Member 3 owns Series B. The Proposed Regulation holds that each Subunit is an entity for federal tax purposes, and an analysis under Treasury Regulation 301.7701-3 finds that Series A is a partnership and that Series B is a disregarded entity.[49]

Finally, the Proposed Regulation sets up a transition rule for Series LLCs that have previously treated themselves in a manner that differs from the Proposed Regulation's guidelines. Under the transition rule, the IRS will respect the taxpayer's prior treatment of Series LLCs, even if that treatment is inconsistent with the terms of the final regulation.[50] In order to qualify for the transition rule, the Subunit must have been established and conducting business or investment activity prior to September 14, 2010; no owner in the Subunit can treat the Subunit as an entity separate from other Subunits in the Series LLC or from the Umbrella LLC; the Series LLC must have a reasonable basis for its claimed classification (within the guidelines of I.R.C. section 6662); and neither the Subunit nor any owner of the Subunit was notified prior to September 14, 2010 that the Subunit's classification is under examination.[51] The transition rule will cease to apply at the point at which fifty percent or more of the ownership of the Series LLC (or Subunit) shifts to a party that did not own an interest in the Subunit as of September 14, 2010.[52]

While the Proposed Regulation is useful in that it provides substantial guidance to those considering the Series LLC structure, it does so in a manner such that it will require careful tax planning in order to maximize the utility of the Series LLC as a vehicle for allocating business or investment assets. Because the Proposed Regulation requires that each Subunit having multiple owners be treated as a partnership and therefore have to file a separate tax return, an optimal arrangement would be one in which each Subunit would be treated as having a single owner, and therefore be disregarded as an entity for federal tax purposes. At the same time, the tax planner must be mindful of the "general tax principles" criteria for evaluating Subunit ownership. One potential alternative for using the Series LLC entity while minimizing tax filing responsibilities would be for a partnership to form a wholly-owned subsidiary LLC to serve as the Umbrella LLC, from which each individual Subunit would be created. In this framework, the partnership would be treated as the sole owner of each of the Subunits in the Series LLC, and the partners of the partnership could allocate items of income and loss from each Subunit at the partnership level. Under such a scenario, the partnership and its partners could fully take advantage of the Series LLC entity structure while minimizing tax

[48] Prop. Treas. Reg. § 301.7701-1(a)(5)(iv).

[49] *Id.* § 301.7701-1(a)(5)(x), Ex. 1.

[50] *Id.* § 301.7701-1(f)(3)(ii).

[51] *Id.* § 301.7701-1(f)(3)(ii)(A).

[52] *Id.* § 301.7701-1(f)(3)(ii)(B).

filing requirements, as the only tax return necessary would be that of the partnership, because the Series LLC and each of its related Subunits would be treated as disregarded entities.

B. State Tax Issues

It is important to consider how the state in which a Series LLC is formed, as well as any state in which the Series LLC or any of the Subunits does business, will each tax the Series LLC and the Subunits.

Before the IRS issued the Proposed Regulation, a couple of states had already treated Subunits of a Series LLC as separate entities for state income tax purposes. For purposes of the California LLC income tax and annual fee, the California Franchise Tax Board treats each Subunit doing business in California as a separate entity if it meets certain criteria.[53] Under these criteria, fewer Subunits would be treated as separate entities than would be treated as separate entities under general federal tax principles. For example, A and B may own each of the Subunits in a Series LLC. If the company agreement provides that A and B will share in all of the income of all of the Subunits and all of the assets of all of the Subunits upon liquidation, those Subunits would not meet the California criteria for treatment as separate entities.[54] However, those Subunits would probably be considered separate entities for federal tax purposes under the Proposed Regulation as long as each Subunit had some kind of business purpose other than tax avoidance.

The Massachusetts Department of Revenue also recognized Subunits as separate entities in 2008 when it issued a letter ruling to a mutual fund stating that if the fund reorganized into a Delaware Series LLC, each Subunit would be treated as a separate entity for Massachusetts income and corporate excise tax purposes.[55] However, the letter ruling was specific to the entities described in the ruling; it expressly declined to rule generally on whether or not each Subunit of a Series LLC would be treated as a separate entity. The Proposed Regulation had not been issued at that time, but the ruling followed the federal tax treatment of regulated investment companies.[56] The letter ruling stated further that classification of each Subunit would follow its classification for federal tax purposes.

In contrast, the Texas Comptroller has elected to treat a Series LLC as a single legal entity which must file one margin tax report under the Umbrella LLC's taxpayer identification number, effectively preventing each Subunit from being taxed separately even though they may not be engaged in a unitary business.[57] For states that have not made any determinations regarding Subunits, the general rule is that they will follow the treatment of Subunits for federal tax purposes. Some states have stated this explicitly.[58]

In spite of the Proposed Regulation and states' general willingness to follow it for state tax purposes, a number of state and local tax issues remain to be addressed. For example, the Proposed Regulation does not have any bearing on the issue of whether the in-state activities of one Subunit can create a nexus to the state for participants in a different Subunit

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[53] FTB Pub. 3556 (Rev. 9-2009).

[54] *See* Jacob Stein, Tilting at Windmills: Examining FTB's Treatment of Series LLCs, 10 BUS. ENTITIES 16 (2008).

[55] Mass. Letter Ruling 08-2 (Feb. 15, 2008).

[56] *See* I.R.C. § 851(g).

[57] Tex. Policy Ltr. Rul. No. 201005184L (May 5, 2010; released Sept. 2011).

[58] *E.g.,* Florida and Illinois. Fla. Dep't of Revenue Tech. Assist. Adv. No. 02(M)-009 (Nov. 27, 2002); Q&A 1 of "Questions and Answers for 2006/2007 Illinois Department of Revenue Practitioners' Meetings," available at http://www.revenue.state.il.us/LegalInformation/Practqna/2006-2007qna.pdf.

within the same Series LLC. Also, just because the states may follow the Proposed Regulation and treat Subunits as separate entities for state income tax purposes does not necessarily mean that they will treat Subunits as separate entities for the purpose of other state and local taxes. On the collections side, states must determine the extent to which they will respect the liability shield between Subunits of a Series LLC organized in a foreign state and refrain from collecting the unpaid taxes of one Subunit out of the assets of another Subunit in the same Series LLC. These and other issues relating to the treatment of Series LLCs for state and local tax purposes remain to be resolved.

C. Federal Employment Tax Issues

Even more issues remain to be resolved with respect to the treatment of Series LLCs for federal employment tax purposes. The Proposed Regulation identifies some of these issues, such as whether the Subunit or the Series LLC will be considered the employer of any employees and whether a Subunit can maintain an employee benefit plan. Entities are not always treated the same for federal employment tax purposes as they are for federal income tax purposes. For example, entities that are disregarded for federal income tax purposes may not be disregarded for federal employment tax purposes.[59] Very little guidance exists on these and other employment tax issues. The Proposed Regulation requests comments on them. Hopefully, the comments will enable the IRS to publish guidance on these issues in the final regulations or in future regulations.

V. BANKRUPTCY TREATMENT AND ISSUES

Despite being an entity option for more than a decade, the validity of the asset segregation of a Series LLC has yet to be tested in bankruptcy court. How a Subunit will be treated in bankruptcy court will ultimately determine the attractiveness of a Series LLC as an entity option. The purported appeal of a Series LLC is the ability to segregate assets into different Subunits within a single LLC rather than establishing an entirely new entity for each set of assets. Thus, if the Subunit segregation is ineffective as to limiting the creditors in a bankruptcy case to the assets of the filing Subunit, the Series LLC has little appeal. Further, how the doctrine of substantive consolidation will be applied to a Series LLC is a significant concern for both potential debtors and creditors. Due to the fact that no bankruptcy court has ushered a Series LLC through the process to date, these questions must be answered by analogy to the treatment of other entities by the bankruptcy courts.

A. Bankruptcy Eligibility of Series LLCs

The threshold question is whether an individual Subunit within a Series LLC can declare bankruptcy at all. The bankruptcy code (the "**Code**") only allows "persons" to file for bankruptcy.[60] Thus, the question is whether an individual Subunit of a Series LLC is a "person" under the Code. If a Subunit is not a "person," then the Umbrella LLC will have to file on behalf of the Subunit, thereby exposing the other Subunits to liability to creditors.[61]

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[59] Treas. Reg. § 301.7701-2(c)(2)(iv) (2012).

[60] 11 U.S.C. §§ 101(13), 109(a) (2010).

[61] *In re* ICLNDS Notes Acquisition, LLC, 259 B.R. 289, 293 (Bankr. N.D. Ohio 2001) (finding that an LLC is a "person" and thus eligible to file for bankruptcy protection despite not being explicitly provided for in the Code).

While Series LLCs are not specifically included in the definition of "person," neither are they excluded.[62] Further, the list of entities defined as a "person" in the Code is prefaced by "includes" which the Code expressly defines as not limiting.[63] Acknowledging the non-exhaustive nature of the definition of "person," bankruptcy courts have previously dealt with other non-listed entities and determined their eligibility by analogy to listed forms.[64] The same analysis can be applied to a Subunit of a Series LLC to determine its likely treatment. Due to the differences in the two types of statutes establishing Series LLCs, the outcome may differ based on the enabling state. For instance, the Illinois-type statutes specifically grant a Subunit separate legal status and require a new filing for each Subunit created whereas the Delaware-type statutes do neither.[65]

How bankruptcy courts treated Traditional LLCs when first faced with the question is instructive as to how they are likely to treat a Subunit of a Series LLC. Like a Subunit of a Series LLC, Traditional LLCs are not specifically mentioned in the Code's definition of a "person."[66] However, the definition found in the Code is non-exhaustive,[67] and when the bankruptcy court first considered the eligibility of a Traditional LLC, it was found to fit the definition.[68] Further, when the Code was significantly revised in 2005, Traditional LLCs were not explicitly excluded from the definition of "person," indicating Congress' assent to the judicial decision to define them as a "person."

In *In re ICLNDS*, the court determined that the list of bankruptcy eligible entities was not comprehensive.[69] Therefore, while LLCs are not specifically granted the ability to declare bankruptcy, they are not necessarily excluded. The court then analyzed the character of LLCs to determine if they are similar enough to corporations or partnerships (both of which are explicitly authorized to file) to warrant bankruptcy protection.[70] The court determined that an LLC

> is a form of legal entity that has attributes of both a corporation and a partnership but is not formally characterized as either one. Generally, an LLC offers all of its members, including any member-manager, limited liability as if they were shareholders of a corporation but treats the entity and its members as a partnership for tax purposes.[71]

The court reasoned that these common characteristics, along with separate legal entity status, made LLCs a sort of hybrid of partnerships and corporations, sharing characteristics with each. Thus, because LLCs draw their character from two entities that are explicitly authorized to seek bankruptcy protection, the court held that LLCs, too, could file for bankruptcy.[72]

This reasoning is likely to also be applied to a Subunit filing for bankruptcy, if that ever occurs. A Subunit under both the Delaware- and Illinois-style statutes are given many

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[62] 11 U.S.C. § 101(41).

[63] *Id.* § 102(3).

[64] *In re ICLNDS Notes Acquisition*, 259 B.R. at 292–93.

[65] DEL. CODE ANN. tit. 6, § 18–215 (2010); 805 ILL. COMP. STAT. 180/37–40 (2010).

[66] 11 U.S.C. § 101(41).

[67] *In re ICLNDS Notes Acquisition*, 259 B.R. at 292; 11 U.S.C. § 102(3) (the former stating that the definition of "person" includes several entities and the latter stating that "includes" is not a limiting term.).

[68] *In re ICLNDS Notes Acquisition*, 259 B.R. at 292–93.

[69] *Id.* at 292.

[70] *Id.* at 292–93.

[71] *Id.* (quoting *In re* DeLuca, 194 B.R. 65, 71 (Bankr. E.D. Va. 1996).

[72] *Id.* at 293.

characteristics similar to those the court found relevant in *In re ICLNDS Notes Acquisition* such as the limited liability for the owners, and the ability to enter contracts and hold assets.[73] Thus, they qualify under part of the test set forth by the court. Because the Illinois statute explicitly grants a Subunit separate legal entity status, and individual Subunits have characteristics similar to other bankruptcy eligible entities, it seems very likely that a Subunit under the Illinois statute will be able to file for bankruptcy as a separate legal entity. The Delaware statute, in contrast, does not explicitly grant a Subunit separate legal status, making a Delaware Subunit's eligibility for bankruptcy less clear.

In absence of clarity of classification in the establishing statute, the court could look to other areas of law to determine how to classify a Subunit. The IRS, as the tax analysis in this article indicates, and the Delaware Department of Finance, Division of Revenue, will likely treat each Subunit in a Delaware Series LLC as a separate legal entity. Therefore, it seems likely that, even without explicit statutory language granting a Subunit separate legal status, the bankruptcy court will consider a Subunit a separate legal entity. If that is the case, then it is likely that a Delaware-type Subunit will also be allowed to file for bankruptcy protection.

Alternatively, a Subunit of a Series LLC under either type of statute could qualify as a "person" under the Code by being classified as an "unincorporated association or company."[74] While the Code does not define these terms, the bankruptcy court has previously found these words to include "persons joining together at least in part for some common business or commercial purpose, and conducting their affairs somewhat after the pattern of corporations."[75] While a single-member Subunit would probably fail to meet this definition, a Subunit with multiple members would likely fit this definition and thus, qualify for bankruptcy protection. This analysis is particularly helpful in determining how a Delaware Subunit will be treated. Under the broad definition of an unincorporated association or company, a Delaware Subunit is likely eligible to file for bankruptcy.

Subunits of a Series LLC under both types of statutes clearly have attributes similar to those of entities expressly allowed to file for bankruptcy protection. Thus, the threshold question seems to be whether a Subunit is a separate legal entity. The Illinois-type statutes expressly grant a Subunit separate legal entity status and would likely be eligible to file for bankruptcy protection as an independent legal entity. While the Delaware-type statutes do not expressly grant separate legal entity status to the Subunits within a Series LLC, other considerations could lead a bankruptcy judge to determine that they are eligible for bankruptcy. While it is impossible to tell how a Subunit will be treated until the bankruptcy court actually considers the question, the analysis indicates they will be treated as separate legal entities for bankruptcy purposes.

B. Substantive Consolidation of Series LLCs

Even if a Subunit of a Series LLC can meet the threshold question of being bankruptcy eligible, the threat of substantive consolidation must also be considered. There is a "'modern' . . . trend toward allowing substantive consolidation, due to the increased use of interrelated corporate structures for tax and other business purposes."[76] The power to

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[73] *See* DEL. CODE ANN. tit. 6, § 18–215 (2010); *see also* 805 ILL. COMP. STAT. 180/37–40 (2010).

[74] *See* 11 U.S.C. § 101(9)(A)(iv) (2012).

[75] *In re* T.W. Koeger Trucking Co., 105 B.R. 512, 515 (Bankr. E.D. Mo. 1989) (quoting Pope & Cottle Co. v. Fairbanks Realty Trust, 124 F.2d 132, 134 (1st Cir. 1941)).

[76] Simon v. Brentwood Tavern, LLC (*In re* Brentwood Golf Club, LLC), 329 B.R. 802, 811 (Bankr. E.D. Mich. 2005) (citing Eastgroup Props. v. S. Motel Ass'n, Ltd. 935 F.2d 245, 248–49 (11th Cir. 1991)).

substantively consolidate emanates from the bankruptcy court's equitable powers and "treats separate legal entities as if they were merged into a single survivor left with all the cumulative assets and liabilities (save for inter-entity liabilities, which are erased). The result is that claims of creditors against separate debtors morph to claims against the consolidated survivor."[77] Obviously, if the various Subunits in a Series LLC were to be consolidated in bankruptcy court, the entity would have little appeal as an entity option. The possibility of substantive consolidation should be a concern to creditors as well. Because all assets and liabilities are consolidated, even innocent creditors of non-filing Subunits would be swept into the bankruptcy case. This could harm creditors of non-filing Subunits by having their claims settled out of a common estate that is likely insolvent rather than the assets of the specific borrower the creditor looked to in extending credit.

"[T]he Supreme Court, little more than six decades ago, approved . . . what became known as substantive consolidation."[78] Despite roots in a Supreme Court decision, the concept took time to gain traction.[79] Eventually two dominant methods of applying the doctrine emerged: the Augie/Restivo Banking test and the Auto-Train test.[80] The Augie/Restivo Banking test considers two critical factors to determine whether or not to impose substantive 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 . . . ."[81] The Auto-Train test focuses more on the identity of the debtors and finds a rebuttable presumption that substantive consolidation is appropriate if there is substantial identity between the entities (less than alter ego standard), and consolidation is necessary to avoid some harm or to realize some benefit.[82] The presumption can be rebutted if a creditor can show that it relied upon the separate credit of one of the entities and that it will be prejudiced by the consolidation.[83] However, even if the presumption is rebutted, a bankruptcy court applying this test will still impose substantive consolidation if the benefits of consolidation "heavily" outweigh the harm.[84]

The Court of Appeals for the Third Circuit recently reconciled the two unwieldy tests into a single, more straightforward set of criteria.[85] The court in *In re Owens Corning* held that substantive consolidation will be imposed only where debtors "(i) disregarded separateness so significantly that their creditors relied on the breakdown of entity borders and treated them as one legal entity, or (ii) postpetition [the] assets and liabilities [of the various units] are so scrambled that separating them is prohibitive and would hurt all creditors."[86] This test is designed to minimize the risk to innocent creditors that relied on the separateness of the entities being considered for consolidation.

While it is not clear which of these three tests will emerge as the preeminent theory, it is clear that substantive consolidation is an available tool of equity for the bankruptcy court.

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[77] *In re* Owens Corning, 419 F.3d 195, 205 (3d Cir. 2005) (quoting Genesis Health Ventures, Inc. v. Stapleton, 402 F.3d 416, 423 (3d Cir. 2005)).

[78] *Id.* at 206 (citing Sampsell v. Imperial Paper & Color Corp., 313 U.S. 215 (1941)).

[79] *See id.* at 206–07.

[80] *Id.* at 207.

[81] *Id.* at 207–08 (citing *In re* Augie/Restivo Baking Co., 860 F.2d 515, 518 (2d Cir. 1988) (internal quotation marks and citations omitted)).

[82] *See* Simon v. Brentwood Tavern, LLC (*In re* Brentwood Golf Club, LLC), 329 B.R. 802, 812 (Bankr. E.D. Mich. 2005) (citing *In re* Standard Brands Paint Co., 154 B.R. 563, 569 (Bankr. C.D. Cal. 1993)).

[83] *See id.* at 812.

[84] *Id.*

[85] *In re Owens Corning*, 419 F.3d at 211.

[86] *Id*.

Because the Subunits of a Series LLC will likely be related to each other in various ways, due care should be taken to minimize the risk of being consolidated. Specifically, each Subunit should be operated as a separate entity despite common membership with other Subunits in the group, and all finances should be kept clearly separate. Further, creditors should be explicitly made aware of the nature of the asset allocation among the Subunits to avoid confusion. The last point is particularly relevant for Series LLCs under the Delaware-type statutes that do not require separate filings for each Subunit, which would give constructive notice to would-be-creditors of the segregation of assets.

VI. CONCLUSION

While new laws and recently released tax guidance may resolve some of the critical questions surrounding Series LLCs, they remain fraught with uncertainty. Series LLCs were developed with the goal of simplifying corporate organizations. Therefore, there is a good possibility that legislatures will eventually tackle the remaining obstacles to Series LLCs becoming more widespread. Until this happens, it is unclear whether, and to what extent, practitioners and their clients will decide that the benefits of Series LLCs are great enough to warrant the risks they entail.