
Creative Asset Protection Planning with LLCs

1. Series LLCs

Similar to corporations, LLCs generally protect owners from lawsuits directed against the entity. However, the assets within the entity are not protected from such lawsuits and the creditor of the LLC may be able to reach the entity's assets. Accordingly, instead of placing all assets in one LLC, practitioners advise clients to form multiple LLCs, placing a single asset in each LLC. At times, lenders also require borrowers to hold collateral in so-called special purpose (bankruptcy remote) entities, with each entity holding a separate piece of collateral.

For a client that owns a couple pieces of real estate (or other business assets) this structure works well. For a client with a multitude of assets the fees (such as the minimum franchise tax imposed on each entity) and costs of setting up dozens of entities add up quickly. Series LLCs ("Series LLCs") are a creative solution.

The concept of the Series LLC has been adopted from the offshore mutual fund industry where segregated portfolio companies and protected cell companies have been in existence for quite some time. These concepts exist in such countries as Guernsey, British Virgin Islands, Bermuda, the Cayman Islands, Mauritius and Belize. In the United States, the concept of a Series LLC was first introduced in Delaware in 1996.¹ The Delaware Series LLC statute was initially introduced for the mutual fund industry, as an extension of the series fund concept.²

Series LLC legislation have now been adopted in Oklahoma,³ Iowa,⁴ Illinois,⁵ Utah,⁶ Tennessee⁷ and Nevada.⁸ All the states with a series LLC statute modeled their laws on the Delaware law, with some deviations in the Illinois legislation (discussed below). Because most series statutes are similar to Delaware, Delaware series laws will be used to frame this analysis.

Title 18, Delaware Code, Section 18-215(a) provides:

A limited liability company agreement may establish or provide for the establishment of 1 or more designated series of members, managers or limited liability company interests having separate rights, powers or duties with respect to specified property or obligations of the limited liability company or profits and losses associated with specified property or obligations, and any such series may have a separate business purpose or investment objective.

Section 18-215(b) provides:

...if separate and distinct records are maintained for any such series and the assets associated with any such series are held...and accounted for separately from the other assets of the limited liability company, or any other series thereof, and if the limited liability company agreement so provides, and if notice of the limitation on liabilities of a series as referenced in this subsection is set forth in the certificate of formation

¹ 6 Del. Code Section 18-215. It should be noted that Delaware also provides for series limited partnerships, 6 Del. Code Section 17-218(b), and series statutory trusts, 12 Del. Code Section 3804(a).

² The concept of a series fund dates back to the Investment Company Act of 1940.

³ 18 Okla. Stat. Section 18-2054.4.

⁴ Iowa Code Section 490A.305.

⁵ 805 ILCS 180/37-40.

⁶ Utah Code Ann. Section 48-2c-606.

⁷ Tenn. Code Ann. Section 48-249-309.

⁸ NRS Section 86.291.

of the limited liability company, then 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 such series only**, and not against the assets of the limited liability company generally or any other series...[Emphasis added.]

Until recently, Delaware treated series as merely a bookkeeping concept, the series were not granted the power to sue, enter into contracts, etc.⁹ Delaware legislature passed Senate Bill 96 that went into effect on August 1, 2007 and expanded the powers given to a series. For example, a series can now enter into contracts, hold title to assets, grant liens and security interests and sue or be sued.¹⁰

In several other respects, series are not treated by Delaware as separate entities. For example, series are not separately registered and they cannot merge or consolidate with other entities, convert into other entity types or domesticate to another jurisdiction. The Delaware Division of Corporations will not provide a separate certificate of good standing for each series.

Illinois has taken a much clearer stance on treating series as separate entities. Illinois law specifically states that a series of an LLC "shall be treated as a separate entity to the extent set forth in the articles of organization,"¹¹ and then also provides that each series 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..."¹² Illinois specifically requires that each series of an LLC be designated on the articles of organization and levies an additional \$50 filing fee for each registered series.¹³

The other five states that have enacted series legislation do not treat series as separate entities and do not allow series to enter into contracts or sue or be sued.

Delaware further provides that to achieve the liability segregation that the series afford (the "internal shield"), the LLC must keep a separate set of books and records for each series, and to have a series enabling statement in its Certificate of Formation.

The following additional characteristics of a series LLC should be noted:

- (i) each series may have different members and managers, and the members of one series may have different rights, powers and duties from members of other series;
- (ii) each series may have a different business purpose or investment objective;
- (iii) statutory restrictions on distributions are applied separately to each series;¹⁴
- (iv) if a member redeems an interest in one series, he does not cease being a member of any other series;¹⁵ and
- (v) a series may be terminated without dissolving the LLC.¹⁶

Series LLCs offer the advantages of cost savings and simplified administration. If an owner of multiple parcels of real estate can use one Series LLC instead of multiple LLCs that allows for an effective reduction of filing fees,

⁹ See, e.g., H.R. 528, Section 9, 70 Del. Law Ch. 360 (1996) "a limited liability company may provide that such series shall be treated in many important respects **as if** the series were a separate limited liability company..." [Emphasis Added.]

¹⁰ 6 Del. Code Section 18-215(c).

¹¹ 805 ILCS 180/37-40(b).

¹² Id.

¹³ 805 ILCS 180/50-10.

¹⁴ 6 Del. Code Section 18-215(h).

¹⁵ 6 Del. Code Section 18-215(i).

¹⁶ 6 Del. Code Section 18-215(j).

annual franchise taxes, legal fees connected to drafting operating agreements and possibly accounting fees. Because Series LLCs exist in a few states and there is no case law examining Series LLCs, several open questions remain as to their viability in other states. Here we will focus on the viability of a Series LLC in California.

a. Recognition of the Internal Shield by California

The major argument against the use of Series LLCs is the uncertainty of the recognition of the internal shield by a foreign state (like California) that does not have a Series LLC enabling statute. States that have enacted Series LLCs legislation usually expressly recognize the internal shield of Series LLCs formed in other states.¹⁷ If a Series LLC registers to do business in California or is involved in litigation in California, will a California court apply Delaware law and limit a creditor's ability to reach all of the assets of the LLC, or will the court apply California law and disregard the internal shield of the series? This question is traditionally known as the "choice of law" analysis and has been codified in California, with respect to LLCs, in Corporations Code Section 17450(a).

Section 17450(a) provides that "the laws of the state...under which a foreign limited liability company is organized shall govern its organization and internal affairs and the liability and authority of its managers and members." The statute addresses two distinct sub-issues of choice of law: (i) when will California follow the laws of a foreign jurisdiction with respect to the internal affairs of an LLC (generally known as the "internal affairs" doctrine); and (ii) when will California follow the laws of a foreign jurisdiction with respect to holding managers and members personally liable.

The internal affairs doctrine has been interpreted to apply only to the internal affairs of a legal entity, its internal structure and workings, and should have no impact on anyone outside of the legal entity.¹⁸ In a recent unpublished opinion, interpreting Cal. Corp. Code Section 17450(a), a federal district court concluded that the internal affairs doctrine, as codified in Section 17450(a), "does not apply to disputes that include people or entities that are not part of the LLC."¹⁹ A similar conclusion was reached by another federal district court when it held that the internal affairs doctrine "recognizes that only one state should have the authority to regulate a[n LLC's] internal affairs. Different conflicts principles apply, however, where the rights of third parties external to the [LLC] are at issue."²⁰

The second clause (governing liability of managers and members) is clearly inapplicable in a Series LLC analysis. With a Series LLC, the issue is not whether a plaintiff or a creditor can pierce the LLC and reach the personal assets of the member, but whether a creditor of an LLC should be limited to only some of the assets of the LLC because the rest are sequestered in separate series.

The above analysis of Section 17450(a) suggests that a Series LLC registered to do business in California would not be able to rely on the internal affairs doctrine to retain its internal liability shield in California. The analysis then necessarily reverts back to the traditional common law "choice of law" scrutiny which has been summarized as follows: "The local law of the state of incorporation will be applied unless application of the local law of some other state is required by reason of the overriding interest of that other state in the issue to be decided."²¹

¹⁷ See, e.g., 6 Del. Code Section 19-215(m).

¹⁸ Bishop and Kleinberg, Limited Liability Companies: Tax and Business Law, 6.08[4] (WGL 2007), citing Restatement (2d) of Conflicts of Laws, Section 302, comment a (1971).

¹⁹ Butler v. Adoption Media, LLC, Not Reported in F. Supp. 2d, 2005 WL 2077484 (N.D. Cal. 2005).

²⁰ Chrysler Corp. V. Ford Motor Co., 972 F. Supp. 1097, 1103-1104 (E.D. Mich. 1997).

²¹ Restatement (2d) of Conflicts of Laws Section 302, comment b (1971).

California has never articulated an “overriding interest” or any other public policy grounds to disregard the internal shield of Series LLCs. That, however, does not mean that such an interest or a policy do not exist.

This determination will be made by the courts on a case by case basis. The court would weigh the injuries suffered by a California plaintiff, and how disregarding the internal shield would help remedy such injuries, against the interests that members of other (non-debtor series) may have in the assets of the non-debtor series. It is possible to hypothesize a situation that would allow a California court to find an “overriding interest” in applying its own law.

Until this question is litigated in a California courtroom, the viability of Series LLCs for owning California assets or for transaction business in California will remain in question. However, if the choice is between using one LLC to own multiple properties and one Series LLC to own multiple properties, there is no disadvantage in using a Series LLC, and all of the possible liability segregation advantages of a series structure (if upheld in a California courtroom).

b. California Income Taxation

For income tax purposes, California Franchise Tax Board (the “FTB”) piggy-backs its treatment of legal entities on the federal income tax rules.²² Consequently, for income tax purposes California will treat each series as a separate taxpayer only if for federal income tax purposes each series should be treated as a separate taxpayer. There are no federal cases or rulings dealing with income tax treatment of Series LLCs. Because Series LLCs are conceptually similar to series trusts, some guidance can be gleaned from the tax treatment of series trusts. In one tax court case, the separate series of a trust were each held to be separate regulated investment companies, and therefore separate entities for income tax purposes.²³ The Internal Revenue Service has adopted this approach to all series trusts.²⁴

Comparing a Series LLC to a series trust is somewhat of a fallacy. Trusts and LLCs are taxed differently. For example, a limited liability company, under the “check-the-box” rules, can be taxed as a disregarded entity, a partnership or a corporation.²⁵ If the LLC is taxed as a partnership or a corporation, then one could further investigate whether each series should be a separate partnership or corporation for income tax purposes. If the LLC is taxed as a disregarded entity, then the treatment of each series for income tax purposes is a moot point, everything is disregarded.

The proper income tax treatment of Series LLCs may also depend on the underlying state statute. For example, an Illinois Series LLC is more likely to be treated as a composition of multiple tax entities than a Nevada Series LLC. If a Nevada Series LLC has the same exact members and managers in each series, same voting and distribution rights, and solely different assets with liability segregation, arguing for multiple tax-entity status would be difficult. Even under the pre-check-the-box rules, finding separate tax entities solely because of liability segregation seems like a stretch. Under the check-the-box rules, the argument becomes even more difficult.

The check-the-box rules apply to “business entities.”²⁶ The regulations do not define a “business entity” and it is not clear, except in Illinois, whether a series of an LLC would be deemed an entity under the applicable state law.

²² Rev. and Tax. Code Sections 23038(b)(2)(B)(ii) and (iii). See also Sections 17851 and 23800.5.

²³ National Securities Series – Industrial Stock Series, 13 T.C. 884 (1949). It is not clear how the analysis of this case fares in light of the later-adopted “check-the-box” rules discussed below.

²⁴ Rev. Rul. 55-416, 1955-1 C.B. 416; PLRs 9837005, 9847013, 9435015.

²⁵ Treas. Reg. Section 301.7701-3.

²⁶ Treas. Reg. Section 301.7701-2.

c. California Franchise Taxes

The FTB has issued instructions to Forms 568 and 3522 directing taxpayers to pay a separate \$800 franchise tax for each series of an LLC.²⁷ Additionally, the FTB included more specific instructions in Publication 3556, Tax Information for Limited Liability Companies:

For purposes of filing in California, each series within a Series LLC must file a separate Form 568, Limited Liability Company Return of Income, and pay its separate LLC annual tax and fee if it is registered or doing business in California, and both of the following apply:

1. The holders of interest in each series are limited to the assets of that series upon redemption, liquidation, or termination, and may share in the income only of that series.
2. Under state law, the payment of the expenses, charges, and liabilities of each series is limited to assets of that series.

Note that Publication 3556 applies only if all of the requirements set above apply. The requirements are actually numerous: members are limited only to the assets of their respective series on a liquidating event, members may not share in the income of the other series, and the payment of expenses of each series is limited to the assets of that series. Many Series LLCs can be structured so as to fail one or several of the above requirements without sacrificing the internal shield.

For example, assume each series of a Series LLC is owned by brothers Abe and Ben. The LLC provides that Abe and Ben share in all of the income of all of the series and share in all of the assets of all of the series on liquidation. So long as Abe and Ben maintain separate books and records for each series, the internal shield survives intact (the separate books and records is the only mandatory requirement for the internal shield, all other provisions are discretionary). Consequently, Abe and Ben are not subject to multiple franchise taxes on their Series LLC.

It is also important to remember that the instructions in these forms merely express the FTB's position and are not a statement of the law. As the below analysis suggests, the position adopted by the FTB is devoid of any legal substance.

The FTB has not publicly disclosed the substance behind its position on Series LLCs. The author, over the past two years, has engaged in written correspondence with various FTB attorneys concerning the franchise tax treatment of Series LLCs. Based on that correspondence, the FTB's position is based on the following arguments:

1. For income tax purposes series may be treated as separate tax entities (see discussion above).
2. A series of an LLC is treated as a separate "limited liability company" pursuant to Rev. and Tax. Code Section 17941(d).
3. Cal. Corp. Code Section 17450(a) does not apply to an LLC's classification for tax purposes.

Let us examine each of the points raised above. The FTB first argues that Rev. and Tax. Code Sections 23038(b)(2)(B)(ii) and (iii) mandates the classification of a business entity for California tax purposes to be in line with the federal entity classification rules. This argument makes no sense as the above Rev. and Tax. Code Sections deal with the classification of a business entity as a corporation v. a partnership v. a disregarded entity. These sections do not address whether a business entity exists in the first place.

²⁷ The \$800 annual franchise tax is imposed under the authority of Rev. and Tax. Code Section 17941(a).

The FTB then argues that because for income tax purposes each series may be treated as either a separate tax partnership or a separate corporation (see discussion above), California has the ability to subject each series to a separate franchise tax. This is a wishful leap of reasoning.

Rev. and Tax. Code Section 17941(a) authorizes the \$800 on each limited liability company registered with the state. The statute specifically refers to a “limited liability company.” There are no references to income tax partnerships, corporations, disregarded entities, etc. The only relevant test is whether a series is a “limited liability company.” How it may be taxed for income tax purposes is entirely irrelevant.

To further illustrate this point, compare a series of an LLC to a general partnership. A general partnership is treated as a partnership for income tax purposes and is therefore an entity for income tax purposes. Yet, California does not impose a franchise tax on a general partnership, because it is not an entity chartered by any state.

That brings us to FTB’s next contention: a series is a “limited liability company” for purposes of Section 17941(a).

California statutes define a “limited liability company” as an entity that is organized under the California limited liability company act,²⁸ and a “foreign limited liability company” is defined as an entity organized under the laws of a foreign state or country.²⁹ The statutes provide, further, that in order to form a limited liability company, articles of organization shall be filed with the Secretary of State. For franchise tax purposes specifically, a limited liability company is defined as an organization “that is formed by one or more persons under the law of [California], any other country, or any other state, as a “limited liability company” and that is not taxable as a corporation for California tax purposes.”³⁰

If the FTB wants to argue that a series of an LLC is a separate limited liability company, then under the above test the series must be formed as a limited liability company. That is never the case.

A limited liability company cannot be created without the consent of a Secretary of State of some state. The existence of a limited liability company does not commence until the articles are filed and a charter is issued. Because no articles of organization are ever filed for a series of a limited liability company (with the exception of Illinois), a series of an LLC should never be a limited liability company under California law. None of the series jurisdictions include the series within the definition of a limited liability company.

The FTB concludes its arguments by claiming that Corp. Code Section 17450(a) does not apply to classifying an LLC for tax purposes. Which is certainly true. But Section 17450(a) does apply in determining how the state of organization treats the series of an LLC. If, for example, Delaware does not treat a series as a separate limited liability company, California should respect that treatment and under Rev. and Tax. Code Section 17941(d) cannot access the franchise tax.

While Section 17450 is discussed in more detail above, recall that this section forces California to respect the laws of a foreign jurisdiction with respect to the internal affairs of a legal entity. Pursuant to the internal affairs doctrine, the laws of the organizing state control the inner workings of a legal entity. Determining whether a legal entity constitutes one limited liability company or multiple appears to related to the legal entity’s structure, and therefore its internal affairs.

In the case of a Series LLC, all the series comprise one limited liability company under the applicable enabling statutes, not multiple limited liability companies (again, with the exception of Illinois). Consequently, the FTB’s

²⁸ Corp. Code Section 17001(t).

²⁹ Corp. Code Section 17001(q).

³⁰ Rev. and Tax. Code Section 17941(d).

position that each series is a separate limited liability company appears to be in conflict with the California statutes.

The FTB's position is further weakened in cases when the Series LLC owns only few assets in California and mostly transacts its business elsewhere. Assume an Iowa Series LLC has 50 series in existence. Forty-nine own real estate in France, and one owns a hot dog stand in Los Angeles. Because the hot dog series would not be able to obtain a certificate of good standing from Iowa, it would not be able to register with the California Secretary of State as a foreign entity. The Series LLC itself would need to register, and according to the FTB would then be liable for \$40,000 of franchise taxes. This argument is likely to fail on constitutional grounds, but only if a taxpayer litigates. Until then, many taxpayers will continue to follow FTB's instructions and pay unwarranted franchise taxes.

Some commentators have suggested that the FTB's position with respect to the Series LLC franchise tax is not "completely objective."³¹ This author believes that the FTB's position is so devoid of legal merit and is so self-serving so as to be shameful.

d. Recognition of the Internal Shield

The ability of a series of an LLC to seek bankruptcy protection is an unresolved question. Bankruptcy laws allow individuals, partnerships and corporations (and by extension, LLCs) to seek bankruptcy protection.³² In series enabling states other than Illinois, series are not treated as separate entities (although Delaware comes close to that). Series appear to be nothing more than a bookkeeping concept, a virtual walled off part of an LLC. That may suggest that only the LLC can file for bankruptcy protection, not one of its series.

This analysis may be different in Illinois, where series are afforded the status of separate entities.

The next relevant question is whether a series of an LLC can transact business in another state without the LLC itself transacting business in such state? The answer to this question depends on whether a series is treated as a separate business entity. Under the Illinois series legislation a series is expressly authorized to transact business on its own: "If a limited liability company with a series does not register to do business in a foreign jurisdiction for itself and certain of its series, a series of a limited liability company may itself register to do business as a limited liability company in the foreign jurisdiction in accordance with the laws of the foreign jurisdiction."³³ In Delaware and other similar Series LLC jurisdictions series are not treated as separate business entities (although Delaware now allows each series to enter into contracts on its own), which would imply that a series on its own may not register in a foreign state.

Registration in a foreign state is available only to those entities that possess a charter (such as Articles of Organization) from their home state. While Illinois issues an equivalent of a charter to each series, Delaware and the other series states do not. Consequently, a series of a Delaware Series LLC would not be able to register with the State of California, the entire LLC would need to register.

³¹ Bruce P. Ely and Kelly W. Smith, *Series LLCs: Many State Tax Questions Are Raised but Few Answers Are Yet Available*, Business Entities (WG&L), Jan/Feb 2007.

³² 11 U.S.C. Section 109(a), *ICLNDS Notes Acquisition, LLC*, 259 B.R. 289, 292 (Bankr. N.D. Ohio 2001).

³³ 805 ILCS 180/37-40(n).

Similarly, if one series of a Series LLC transacts business in a foreign state, would that mean that the foreign state would acquire jurisdiction and taxation powers over the entire LLC and all of its series or only those series transacting business? The answer again depends on whether the series is treated as a separate entity.

2. Use of Foreign LLCs

California law specifically provides that a foreign LLC registered to do business in California will continue to be governed by the laws of the foreign jurisdiction where it is organized.³⁴ In this context, foreign means any jurisdiction other than California, including sister-states. That is why a Series LLC should work in California (noting, however, that a California court has yet to opine on Series LLCs).

Jurisdiction shopping for LLCs is relatively simple if one knows the client's objectives. For tax minimization, if the LLC is taxed as a partnership or a subchapter S corporation,³⁵ its state of formation is irrelevant to a member residing in California. California would tax any resident member on its allocable income. If the LLC is taxed as a subchapter C corporation, jurisdictions like Nevada or South Dakota (or even some foreign countries that do not impose an income tax) may be good choices because there are usually no corporate income taxes in these jurisdictions. However, this will work only if the business is either located in that jurisdiction³⁶ or it has no easily ascertainable physical location (such as Internet-based business).

For liability protection many look to jurisdictions like Delaware and Nevada, domestically, and such foreign jurisdictions as the Island of Nevis or St. Vincent and the Grenadines (both in the West Indies) that have an established history of making it difficult for creditors to pierce the corporate veil of an LLC.

Another advantage of using a truly foreign LLC for asset protection purposes is that the legal battle moves offshore. With respect to LLCs, even if they hold U. S. real estate, the applicable law is always the law of the jurisdiction where the LLC is organized. Various offshore jurisdictions are more protective of LLC members than U. S. jurisdictions, such as restricting the creditors solely to the charging order, and respecting single-member LLCs as separate entities.

A foreign LLC also presents the creditor with the disadvantage of the increased costs of litigation, as the proceeding may have to be brought in a foreign country to either obtain a judgment or collect on a judgment.

Care should be exercised in the types of assets that the foreign LLC will own. For example, unless the foreign LLC is a single-member LLC and is disregarded for tax purposes, it cannot hold S corporation stock.

Clients often seek to protect corporate assets from creditor claims which may be prohibitive from a tax standpoint if the corporation is liquidated. Even with an S corporation, there will be an "exit" tax to the extent the corporation has appreciated assets. Transferring the stock of the corporation to a single-member LLC that is disregarded for tax purposes may be the best solution. Because there is some uncertainty as to how much protection domestic single-member LLCs afford, a foreign jurisdiction with a track record of respecting single-member LLC may be preferable.

³⁴ Corp. Code Section 17450(a).

³⁵ A limited liability company can file the IRS Form 8832 to elect to be taxed as a corporation, and then make a subchapter S election.

³⁶ If an entity is organized in Nevada (for instance), but is doing business in California, California will always tax that business on its income apportionable to California, regardless of the state of organization or type of entity.

3. **Protection of Business Assets**

Another way LLCs may be used to limit liability exposure is to form multiple (or series) LLCs to own separate, distinct portions of a business. If the business is held in one entity, all the assets of the business are exposed to risks and liabilities arising out of all the various business assets and operations. This is best illustrated by an example.

Tireco, Inc. owns a patent to an automobile tire and also manufactures and sells the tire. If a tire becomes defective and results in damage, the lawsuit will be filed against Tireco, as the manufacturer and seller of the tire. The lawsuit, assuming it is successful and exceeds the insurance coverage, would reach Tireco's assets (including the very valuable patent) and possibly place it in bankruptcy.

The solution is for Tireco to continue to manufacture and sell the tires but to form a separate LLC to own the patent, with a non-assignable licensing agreement between the two entities. If a lawsuit is filed against Tireco, the creditor would not be able to reach the patent. Note, however, that this protection may be undone by a successful alter ego challenge or "substantive consolidation" in a bankruptcy proceeding.

Any business with significant assets should consider forming a separate LLC for each distinct segment of its business or to hold valuable assets. Taken a step further, each significant asset of a business can be insulated using a Series LLC, with a separate licensing agreement (if appropriate) running from each series to the operating entity.