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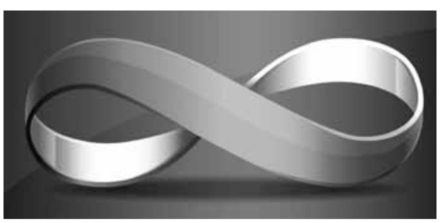
Series of Unincorporated Business Entities: the Mobius Strip and Klein Bottle of Business Entity Law

By Daniel S. Kleinberger

Möbius strip, a one-sided surface that can be constructed by affixing the ends of a rectangular strip after first having given one of the ends a one-half twist. This space exhibits interesting properties, such as having only one side and remaining in one piece when split down the middle.



Klein bottle, topological space, named for the German mathematician Felix Klein, . . . not constructible in three-dimensional Euclidean space but [with] interesting properties, such as being one-sided, like the Möbius strip; being closed, yet having no "inside" . . . ; and resulting in two Möbius strips if properly cut in two.

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Back in the day – say, 1990 – limited liability companies (LLCs) were the cutting edge of business entity law. Today, LLCs dominate entity formation, and the cutting edge has moved further out – to the notion of a "series," a quasi-separate, quasi-person existing within an LLC.

Business lawyers are generally familiar with series of stocks and bonds, but those series have nothing to do with the LLC series discussed in this article. To avoid confusion, this article refers to *protected* series, which, as we will see, are the Mobius strips or Klein bottles of entity law.

The Protected Series Construct

The protected series comprises an identifiable set of assets segregated within a limited liability company (or also, under Delaware law, within a limited partnership), with the following features:

- Those "associated" assets constitute the series, and a series is empowered to conduct activities in its own right. A series and its associated assets are responsible only to persons asserting claims pertaining to those assets or activities.
- The associated assets are *not* responsible to persons asserting claims arising from the assets or activities of the LLC itself or from any other set of assets segregated within the LLC (i.e., from any other series within the LLC).
- One or more members of the LLC may be, but are not necessarily, associated with the series.
- The profits of the series inure to the benefit of only the members associated with the series, or if there are none, the LLC itself.

Thus, an LLC that has protected series perforce has "internal shields" – i.e., the partitions confining the assets and liabilities of each series to that series alone. These shields are conceptually and practically quite different from the shield that protects the owners of an entity from automatic liability for the entity's obligations.

As detailed below, no one knows whether the internal shields will work in bankruptcy. Accordingly, this article is a warning label, not an operator's manual.

What's Old and What's New?

The protected series has long existed in the context of series of investment trusts (particularly Delaware statutory trusts) and in the kindred context of captive insurance companies. However, in those contexts:

- the construct has the blessing (and supervision) of the relevant regulators; and
- the internal shields are not at issue, because:
  - involuntary creditors are as plentiful as unicorns; and
  - voluntary creditors will promise not to challenge the internal shields.

In 1996, Delaware amended its LLC and limited partnership statutes to provide for protected series. At that time, the thought seemed to be a combination of "why not?" and "perhaps in some circumstances an LLC or LP might work marginally better than a series within a Delaware statutory trust." None of the key architects of the series provisions of the Delaware LLC and LP statutes then envisioned, let alone advocated, using series to compartmentalize the activities of operating businesses.

That attitude may well remain "best practices." For example, the LLC Committee of the ABA Business Law Section has begun drafting a model operating agreement for a multi-member Delaware LLC with protected series. The project assumes that the LLC will be an investment vehicle and not an operating business or holding company.

However, anecdotal evidence suggests that many "series LLCs" are indeed used for operating businesses and holding companies and that many lawyers are recommending (or at least countenancing) such purposes.

Twelve states, the District of Columbia, and Puerto Rico now have series provisions in their respective LLC acts, and on Google the hits for "series LLC" go on almost endlessly. More than 25,000 series now exist under Illinois law alone.

These developments are occurring even though the efficacy of a protected series' internal shields remains in doubt and many other important question are as yet unanswerable.

The Import of the Series Construct in Other Areas

Outside the realm of investment funds and captive insurance companies, the protected series is one of the most significant developments in the law of business organizations since the advent of the LLC. The series:

- pushes the conceptual envelope of entity law by providing for a quasi-distinct legal construct existing *within* an overarching entity; and
- establishes a new type of liability shield – rather than protecting the owners of an organization from vicarious liability for the organization's debts, the "internal shields" of a protected series protect the assets of one protected series from the creditors of the overarching entity and any other protected series of that entity.

Enter the Uniform Law Commission

The Uniform Law Commission ("ULC" or "Commission") (formerly known as the National Conference of Commissioners on Uniform State Laws), is a long-established (est. 1892) non-profit that develops and supports the enactment of uniform state statutes. The Commission's most famous uniform act is the Uniform Commercial Code. The Commission's earliest business organizations act was the 1914 Uniform Partnership Act.

In 2011, the ULC established a study committee to consider whether to draft a uniform act providing for protected series. A Drafting Committee began work in 2013 and is expected to finish work in 2015.

The committee's work has been complicated, because a uniform business entity act must be "self-executing" – that is, the act must (1) take into account that most business entities are formed without legal advice, and (2) provide sufficient "default rules" so as to allow an entity to function without its owners having specified the rules that govern their *inter se* relationship. As a result, the Drafting Committee is identifying and addressing numerous issues that current series statutes address vaguely or not at all. As explained below, a uniform act can resolve some of those issues but not all.

ULC Drafting Committee Key Issues

Will the Internal Shields Hold?

No series act can directly answer these questions, because they implicate the Supremacy Clause (bankruptcy law) and choice of law doctrine (states without series legislation). The "internal affairs" doctrine does not control the choice of law question, because the internal shields dramatically affect the rights of creditors in a quite novel way.

As for the internal shields under bankruptcy law, no directly relevant case law exists. The safest approach would be to characterize the protected series as a separate entity and provide the series the full spectrum of entity powers. However, most series statutes duck the characterization issue, declining even to define a series as a separate "legal person." As for entity powers, a series can contract, own property, and sue and be sued, but cannot exist except within the overarching organization (i.e., an LLC, or under some statutes, a limited partnership).

For investment trusts and captive insurance companies, a "non-entity" approach is essential for regulatory reasons. But outside those contexts the aversion to entity status remains unexplained – even though this aversion might conceptually undermine the shields. Moreover, there may be practical problems with saying, "It looks like a duck, quacks like a duck, swims like a duck, but it's not a duck. Mobius strips and Klein bottles may seem real to mathematicians, but the series as non-entity, non-person may be so counter-intuitive to judges as to encourage piercing, substantive consolidation, and other theories of affiliate liability.

In sum, with regard to the internal shields, the only thing we know for sure is that we know nothing for sure.

> *The Drafting Committee's current approach*: A protected series is a person distinct from the series organization, other series of the organization, and the owners of the organization. A series cannot exist on its own.

Will Other Important Areas of Business Law Accommodate the Series?

The California Franchise Tax Board has decided to treat protected series as separate entities for filing and tax purposes, and the U.S. Treasury Department has formally proposed to treat each protected series as a separate taxpayer. However, it is uncertain how series will interrelate with other important areas of business law.

The two most important examples are bankruptcy law and Article 9 of the Uniform Commercial Code. As noted above, if bankruptcy law does not respect the internal shields, the shields are worthless. Moreover, if a series cannot enter bankruptcy on its own, the situation will be messy at best.

As for Article 9, that law – not series law – determines where to file a financing statement on assets associated with a series. The determination depends on the Article 9's characterization of the debtor, and for a protected series that characterization involves three questions much at issue under most series statutes: (1) Is a series a distinct entity or at least a juridical person? (2) Does the formation of a series require the filing of a document with the government? (3) Precisely what "interest" does a series have in property associated with the series?

Other examples are perhaps less dramatic, but nonetheless involve serious practical questions. For instance: How does a person make service on a series? How do statutes requiring foreign organizations to register to do business in a state apply to series? For the purposes of establishing personal jurisdiction over a series or an LLC with series, are the activities of the "parts" aggregated in a whole?

> *The Drafting Committee's current approach*: A series is a person whose formation requires the public filing of a document. One serves a protected series by serving the LLC. For purposes of foreign registration and personal jurisdiction, each series is distinct from the LLC and any other series of the LLC.

Who Owns Property "Associated" with a Protected Series?

To indicate that a particular protected series encompasses particular assets, series statutes use "associate" as the term of art. However, these statutes do not describe a series as "owning" associated assets. The statutes refer instead to "assets of a series."

If "assets of a series" means something less than ownership, the phrase is at best ambiguous. For the internal shields to function as intended, a series must have exclusive rights in its associated assets vis-à-vis the LLC and any other series of the LLC. Only in this way can those assets be made available solely to the series' creditors, safe from competing claims from creditors of the LLC and other series. To have exclusive rights in property means to own the property.

> *The Drafting Committee's current approach*: "Property associated with a protected series is owned by the protected series."

How Property is Associated with a Protected Series

Associating property with a protected series is a matter of recordkeeping. Property is associated when the LLC's records adequately identify the property and the series that owns the property. Series statutes delineate adequacy in various ways, but in all events the standard is objective. No existing statute requires associated property to be titled in the name of a series, even if the property is subject to a public recordation system (e.g., land, motor vehicles).

Inadequate documentation imperils the internal shields, but to what extent? Current statutes appear to take an all or nothing approach. Either a series maintains generally adequate documentation and its internal shield works generally, or not. That is, generally inadequate documentation removes the shield even as to property documented with superlative specificity.

In the alternative, adequacy could be determined asset by asset and the shield applied accordingly.

> *The Drafting Committee's current approach*: Adequate documentation and shield protection are determined asset by asset. No consensus has yet formed around the recordation issue.

Duties of Those Who Manage a Protected Series

Absent a contrary agreement, as a matter of agency law, a person who manages a protected series owes fiduciary duties. But who has standing to enforce those duties: The series itself? The members associated with the series? The LLC?

In entity law generally, standing belongs to the person directly injured, subject to an owner's right to bring derivative claims. This approach may well be apt for protected series.

> *The Drafting Committee's current approach*: In general, whatever rules of standing apply to the LLC apply as well to each protected series. However, a member not associated with a protective series has no standing to bring a derivative claim pertaining to the series.

Competition Between an LLC and its Protected Series

No current statute addresses this issue; resolving the issue is accordingly the burden of those who draft operating agreements providing for protected series. The "rub" is likely to occur when the LLC manages more than one of its series.

> *The Drafting Committee's current approach*: "A series manager of one protected series of a series organization does not in that capacity owe any fiduciary duties to another protected series

of the organization or [to] the owners associated with another protected series." The Committee has instructed the Reporter to draft around "the Sinven problem." *Sinclair Oil Corp. v. Levien*, 280 A.2d 717 (Del. 1971) (shareholders of one corporate subsidiary [Sinven] brought derivative claims against the parent in part because the parent had allocated a business opportunity to another subsidiary).

Relationship of an LLC's Operating Agreement to a Protected Series

Even though their formation requires a public filing, LLCs are very much creatures of contract. The same is true for protected series. Accordingly, once an LLC has established a series with at least one associated member, myriad contract issues arise. They include:

- novel complexities of contract interpretation;
- the need for a default rule for amending a provision of the operating agreement specific to one series;
- the need to address the consequences when an amendment to a generally-applicable provision of an operating agreement disproportionately prejudices a series or its associated members.

No current statute addresses any of these issues.

> *The Drafting Committee's current approach*: The committee is aware of these issues but has not yet reviewed any proposed statutory language.

What Does the Public Need to Know About a Protected Series?

Following Delaware's lead, almost every current series statute empowers an LLC to establish a protected series through a private document (the operating agreement), so long as the LLC's articles of formation state that the LLC has the power to establish series. Illinois law takes the opposite approach; an LLC must make a separate public filing to establish each series.

From a transparency perspective, the Illinois approach seems a foregone conclusion. From a political science perspective, the Delaware approach is revolutionary; the sovereign delegates to a private organization the power to equip a private enterprise with a liability shield that abrogates traditional liability rules.

The transparency question informs two issues relating to names. Should the name of a protected series: (1) indicate that the series is a series (a "designator" requirement); and (2) include the name of the LLC as part of the series name?

> *The Drafting Committee's current approach*: To form a protected series requires a publicly filed document, albeit a very simple one. The name of a protected series must include the name of the LLC.

Business Needs Served by the Protected Series Construct

Outside the contexts of investment trusts and captive insurance companies, the special advantages of the protected series remain obscure. For example, an LLC with series can compartmentalize various divisions of an operating company or function as a holding company. But what advantage does the series provide over traditional structures that use separate affiliates to compartmentalize risk?

Though placed last in this article's list of issues, this question may be the most important facing the ULC Drafting Committee. Absent a persuasive answer, skeptics will analogize the protected series to a shell game played to the prejudice of creditors.

Saving filing fees and paperwork cannot alone justify the protected series construct, especially given the uncertainty as to (1) the efficacy of the internal shields; and (2) how series provisions interrelate with important areas of business law. In fact, paperwork requirements for series may be more demanding than for other affiliate structures, because the requirements for associating assets are quite stringent.

Likewise, saving filing fees seems a rather small tail for a rather large and potentially risky dog. For one thing, state governments have a way of noticing when fee revenue decreases. For example, as mentioned above, the State of California has acted proactively to protect its filing revenues (and franchise taxes as well).

Perhaps the protective series remains attractive because it is novel, *appears* efficient, and "none of the chickens (open questions) have yet come home to roost." The directly relevant case law consists of just two cases, neither of which answers any of the important questions.

The ULC Drafting Committee continues to inquire into the question of "series advantages," not only as a response to "shell game" skeptics, but also because a statute should be shaped in light of its primary purpose.

Going Forward

The Drafting Committee's next meeting is March 20–21, 2015. The next draft will be publicly available at the beginning of March. *Comments are welcomed.*

Daniel S. Kleinberger is the reporter for the Uniform Law Commission's Drafting Committee on the Series of Unincorporated Business Entities Act. He serves regularly as an expert witness, consulting expert, arbitrator, and special consensual magistrate. This article reflects Professor Kleinberger's opinions as an individual and does not state the views of the Commission or the ULC Drafting Committee.