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The Benefits And Challenges Of Lending To Series LLCs

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As the private equity asset class continues to expand[1] and private equity fund managers respond to demand by investors for evermore bespoke products and tailored investments, there has been an increase in the use of alternative fund structures to accommodate such demand. In addition to the proliferation of separate accounts, funds-of-one and co-investment structures, the use of vehicles that employ series, cell or other asset and liability segregation technology has increased, bringing with it opportunities and potential challenges when leverage at the fund or individual series level is sought.

The use of series in a limited liability company[2] offers many potential benefits to a private equity fund manager and its investors; however, for lenders interested in advancing credit to a series LLC or a series thereof, it is important to understand how series LLCs differ from traditional forms of limited liability entities. This article discusses the nature and benefits of series entities in the private equity context,[3] as well as potential issues that lenders will want to take into account when considering advancing credit to a series under series entities secured by investor capital commitments.[4]

Background

A series LLC is generally created pursuant to the laws of the applicable jurisdiction of formation. A defining feature of a series LLC is the ability to create an unlimited number of segregated subunits or series under the umbrella of a single “master” LLC (or limited partnership), permitting each series to have separate members, managers, equity interests, assets, liabilities and business objectives associated with it, with an internal liability shield among the series that is intended to be enforceable against creditors and other counterparties. This is in contrast to a traditional limited liability company, which may have different classes of members that have different rights, assets or liabilities associated with such class, but such internal organizational structure is not intended to impact the obligations and liability of the limited liability company as against creditors and counterparties.

At its heart, the series structure promises the ability to segregate the assets and

liabilities of each series, such that the liabilities and other contractual obligations of any given series may be enforced only against the assets of that particular series and not the assets of any other series or the "master" entity itself, so long as the relevant statutory formation and procedural requirements are met.[5] In this respect, a series LLC with liability segregation promises owners the personal liability protection against third parties of a limited liability company while also permitting contractual flexibility to effectively create mini-LLCs under the series LLC umbrella, whose activities are insulated from each other and the series LLC itself. Thus, in the private equity fund context, each series can have different investors, with different investment strategies and commitment periods associated with it, as if each series was an individual stand-alone vehicle.

In the context of a fund formed as a series LLC, each series may be governed by a common master fund-level limited liability company (an "operating agreement"), or by both a series-specific operating agreement (or supplement or addendum) and a master fund-level operating agreement. Each such operating agreement may provide different operational, distribution and membership mechanics with respect to each series, and each series may be administered by a separate manager, although the same manager (or general partner) is often used for all series in a series LLC. Funds may use series LLC technology to facilitate establishment of different investor commitment periods for each series and to house separate investments in individual series, thereby permitting investors to commit capital to the fund for particular periods or specified uses.[6]

Other potential benefits to implementing a series structure include reduced formation and administrative cost. In some states, use of a series LLC allows a fund to avoid registering multiple entities with the state of organization, maintaining multiple registered agents and filing multiple sets of annual reports and tax returns. Further, rather than requiring a fund sponsor to form a new entity each time new investor capital is raised, the fund's operating agreement may provide for the creation of additional series from time to time. Funds that use a master fund-level operating agreement to govern each series may also reduce legal costs associated with the creation and negotiation of multiple fund vehicles and operating agreements. Aside from possible savings attributable to reduced long-term formation and startup costs, use of series entities may result in minimized filing costs, state franchise fees and compliance costs, as well as tax savings when compared to creating separate entities instead of series under a series LLC.

While there are many potential benefits to a series LLC organizational structure, there may be risks in certain circumstances as well. There remains uncertainty as to the state and federal income tax treatment of series entities and the series within a series LLC, as well as their treatment for employment tax purposes.[7] In addition, as more fully described below, it is not clear whether the separate liability protection of a series will be upheld by the courts of a state that has not enacted legislation providing for series provisions for state law liability purposes.[8] Further, accountants, lawyers and other service providers may not have sufficient familiarity with the series structure to provide adequate advice on the unique issues that may arise in relation to a series LLC.

Facility Structure and Loan Documentation; Special Considerations for Series Entities

The basic loan documentation for a facility advanced to a series under a series LLC borrower is similar to the loan documentation typically used for a fund that does not have a series construct and will usually include the following: (a) a credit agreement that contains all of the terms of the loan, borrowing mechanics, conditions precedent, representations, warranties and covenants, events of default and miscellaneous provisions typically found in a commercial credit agreement; (b) a promissory note; (c) a pledge or security agreement pursuant to which the lender is granted a security interest in the

collateral; (d) account control agreement(s) over the account(s) into which investors fund capital contributions in response to a capital call to perfect the lender's security interest therein and permit the lender to block withdrawals from such account(s); (e) Uniform Commercial Code financing statements filed with respect to Article 9 collateral against the applicable debtors; and (f) other customary deliverables, such as officer's certificates certifying the relevant organizational documents, resolutions and incumbency signatures, opinion letters and other diligence deliverables, as appropriate. While the basic loan documents required under a facility made to a series under a series LLC are comparable to those under a facility made to a traditional commingled fund, there are a number of potential issues that should be considered during the underwriting and documentation process, as more fully described below.

Operating Agreement Provisions

As with any fund finance product, the operating agreement of a series LLC will need to be scrutinized prior to execution of a facility to ensure that the operating agreement contains adequate facility-related provisions. In addition, because the assets and liabilities of a series in a series LLC are often intended to be separate and distinct from those of another series and the series LLC itself, the lender will need to confirm whether the operating agreement adequately provides for such segregated liability. This is particularly important in determining the borrower structure, understanding which capital commitments are associated with (and thus available to) which series, and assessing the potential impact on one series of debt being incurred by another series. For example, in the operating agreement for a series LLC, one would expect to see prohibitions on the ability of the fund manager to issue a capital call to, incur indebtedness on behalf of, or grant a security interest in the assets of one series to repay indebtedness incurred with respect to another series. As such, the borrowing base for a facility involving a series LLC would need to be established on a series-by-series basis, with several liability among the series. As described above, however, there are funds that employ series technology for reasons other than asset and liability segregation, in which case, a joint and several series-borrower structure may be permissible, which would impact how a lender underwrites a facility.

State Law, Recognition by Courts and Bankruptcy Considerations

A lender that is considering offering a facility to a series of a series LLC will want to understand whether the fund's state of formation, as well as the governing law of the facility, recognizes a series LLC structure. The series LLC was first recognized under Delaware law in 1996, and under current Delaware law, a series is authorized, in its own name, to enter into contracts, hold assets, grant liens and security interests in those assets, and sue and be sued.[9] As of the date of publication of this article, however, only about a third of states recognize the series LLC, and among the states that do, there is no uniformity in law.[10] In order for the segregation of assets and liabilities of a series to be recognized, some states require specific legal hurdles to be cleared during the formation process, including the use of specific language applicable to the series in the operating agreement, and some states require certain procedures to be maintained during the life of the fund, such as the maintenance of separate books and records with respect to each series. Other states, such as Illinois, require each series to publicly register with the state. Understanding the state's series LLC statutes will help a lender assess whether the necessary formalities have been observed by the series LLC, whether it is possible to structure a facility to a series of a series LLC on a series-by-series basis, and whether the facility should contain statute-specific covenants.

As the series LLC is a relatively new creature of state law, there is limited jurisprudence addressing the interrelation between states that have statutes that provide for the segregation of assets and liabilities

between series and those that do not, and it is not settled whether courts in states that do not have series LLC statutes would recognize the segregation of assets and liabilities across series formed under the laws of another state with a permitting statute. Further, the treatment of a series LLC and the series thereof under the U.S. Bankruptcy Code is uncertain.[11] It is unclear whether a series may constitute a "debtor" under the Bankruptcy Code and thus if a series may file bankruptcy independent of the series LLC and other related series, and whether a bankruptcy court would uphold the segregation of assets and liabilities if a series related to a series borrower or the series LLC itself was subject to a bankruptcy proceeding.[12]

In addition, a lender should be aware that the application of the equitable doctrine of substantive consolidation could impact the outcome of a bankruptcy case involving a series LLC. The substantive consolidation doctrine permits a bankruptcy court to disregard the separate legal existence of entities when they are determined to operate more as a single entity instead of as separate individual entities. Because the internal liability shield afforded by a series LLC does not hold when a series LLC fails to satisfy the statutory requirements for achieving separate liability, a series LLC may be at greater risk for being substantively consolidated than individual limited liability companies that sit under a parent limited liability company.[13]

As such, to minimize the risk of substantive consolidation, a lender to a series of a series LLC will want to ensure that the series borrower is acting in its own name (which is clearly identified in the operating agreement), is generally acting independently of each other series), maintains separate books and records, does not commingle assets or prepare consolidated financial statements, and is not cross-accelerated, cross-guaranteed or cross-collateralized with any other series or the series LLC. Accordingly, it may be prudent for a lender to require that the operating agreement of each series and/or the series LLC, and any debt instrument entered into by any series or the series LLC and a lender, contain provisions (1) acknowledging the segregation of assets and liabilities among the series, (2) providing that a creditor has recourse only to the assets of the particular series to which the debt relates and not to the assets of the series LLC or any other series, and (3) providing that a creditor shall not be entitled to petition for the liquidation or bankruptcy of any series or the series LLC on the basis of the failure of a borrower series to repay any debts or liabilities owing to a creditor.

On the other hand, assuming no third-party creditor has a lien on the capital commitments related to any other series, one can envision scenarios under which substantive consolidation resulting in elimination of the internal liability shields in a bankruptcy proceeding could potentially benefit a facility lender by increasing the pool of investors upon which a capital call could be made to repay indebtedness. A review of the relevant state statues and case law may reveal that other state-specific provisions should also be included in the loan documentation for facility to a series.

Security Interest and Perfection Matters

State law governing the formation of the series LLC and the series must be carefully considered in connection with secured facilities, as such laws will inform what steps should be taken by a lender to perfect its security interest in the collateral. As a threshold issue, a lender will need to confirm how the capital commitments are held, as series LLC statutes often permit multiple alternatives; for example, the capital commitments under the operating agreement may be held by the series LLC itself, through a nominee or by a particular series of the series LLC, and if held by a series, it is not always clear what the name of the series may be. A series may or may not be a legal person separate from its related series LLC under the laws of its jurisdiction of formation; if the series is not a separate legal person, then the series possibly cannot be a "debtor" for purposes of Article 9 of the Uniform Commercial Code. As a

result, consideration should be given to whether the series LLC, in addition to the series borrower itself, should be included as a grantor under the security and pledge documentation and in the related UCC financing statement filings.

Assuming the series can be a "debtor" under Article 9 of the UCC, the series may not necessarily be a separate "registered organization" for Article 9 purposes, unlike the series LLC itself to which the series is associated.[14] This is relevant for the UCC Article 9 rules for determining where to file a UCC financing statement and the legal name of the series to use in a UCC filing. Under UCC Article 9, a "registered organization" is "located" for Article 9 purposes in the state of its jurisdiction of formation.[15] Thus, for example, a lender would file a UCC against a Delaware limited liability company in Delaware; however, if the Delaware limited liability company is a series LLC, and the borrower series has its sole place of business in New York, then it may be the case that a UCC filing against the series should be in New York and not in Delaware.[16]

Further, the legal name of the series to use for purposes of filing a UCC financing statement may be uncertain given the lender may not be able to look to the "registered organization" naming rule (i.e., one looks to the registered organization's name as stated on the public organic record most recently filed with the organization's jurisdiction of formation (e.g., a certificate of formation for a Delaware limited liability company)). For example, if the operating agreement of ABC LLC provides for Series 2018-1, is the legal name of such series "ABC LLC, Series 2018-1" or "Series 2018-1 of ABC LLC" or "Series 2018-1"? In some cases, the operating agreement or certificate of formation of the series LLC, as applicable, may refer to a series in multiple ways. Because of such uncertainties, it may be prudent for a lender to file multiple financing statements and require that the fund specifically name each series in the operating agreement and refer to each series in a consistent way throughout the operating agreement and in its business dealings. In light of these ambiguities, careful legal analysis will be needed in order to ensure that the lender's security interest in relation to a series borrower is adequately granted and properly perfected. A lender will also want to consider what legal opinions are feasible in light of the potential uncertainty around these collateral issues and what level of opinion comfort it will need in extending a facility to a series.

Other Facility Considerations

As mentioned above, in connection with documenting a facility, the lender should consider whether series-specific and statutory-related restrictions are appropriate. The parties may agree that the creation of a new series or any change to the name or structure of an existing series shall require lender approval. The parties may also agree whether any new series will require lender approval as a general matter, and also prior to such series being added as a borrower and receiving its own borrowing base under a facility (as may be done in a legally several umbrella facility structure). It is not unusual for such facilities to include ongoing representations and warranties to be given by the fund to the lender as to various statements of fact relating to the operating of the series to address the consideration and issues described above. In conceptualizing how to address some of the unique features of a series LLC, lenders may look to some of the technology used in credit facilities to Irish collective asset-management vehicles and Cayman Islands-exempted segregated portfolio companies, which employ segregation technology not dissimilar to a series LLC (albeit, under different legal regimes).

Conclusion

As more fund sponsors consider implementing series LLC structures because of the cost and administrative benefits they may offer, the number of facilities featuring a series LLC is likely to grow in

the coming years. Lenders considering advancing a facility to a series of a series LLC should be aware that there remains uncertainty surrounding the treatment of a series under state law and the Bankruptcy Code, but that there are techniques available to help mitigate the related risks. With adequate legal and credit due diligence and careful structuring, lenders may be able to arrange credit facilities to series that meet the needs of its fund clients while also adequately protecting the lenders' downside credit risk.

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[1] See, e.g., Private Capital: Record-Setting Pace in 2017, Preqin Ltd., http://docs.preqin.com/press/Fundraising-2017.pdf.

[2] Note that some states, including Delaware, also permit both limited partnerships and trusts to elect a series structure. See Del. Code An-notated, Title 12, §3806(b), Del. Code Annotated, Title 17, §218.

[3] This article provides a basic overview of certain potential benefits and challenges of lending to series LLCs. Specific reference to the enacting statutes of a particular jurisdiction and the terms of the constituent documents of a series LLC borrower must be undertaken in assessing the suitability of lending to a series LLC or any series thereof. This article is not a comprehensive treatment of the subject.

[4] By way of background, a subscription credit facility, also known as a capital call facility, is a loan or line of credit made by a bank and other credit institutions to a fund that is secured by (a) the unfunded commitments of the investors to fund capital contributions to the fund when called from time to time by the fund (or its general partner, managing member or manager), (b) the rights of the fund or its manager to make a call (each, a "capital call") upon the capital commitments of the investors and the right to enforce payment of the same, and (c) the account into which investors fund capital contributions in response to a capital call (collectively, the "collateral").

[5] See, e.g., Del. Code Annotated, Title 6, §18-215(b), which requires that various corporate formalities be followed in order to establish a series LLC and achieve asset and liability segregation, including the certificate of formation and operating agreement including notations as to the limitation of liabilities, maintenance of proper books and records, and accounting for the assets and liabilities of each series on a separate basis.

[6] There are numerous other potential applications of the series construct in a fund context. Series LLC technology may be used to facilitate co-investments and as a means to internally track revenue streams and asset allocations within a fund. A fund-of-one may use series LLC mechanics to manage investment activities and annual spending with a particular manager, using, for example, a new series corresponding to annual commitment periods or to cap capital commitments with respect to particular investments. In such cases, the need for a liability shield as between various series within a particular series LLC may or may not be a primary factor in selecting a series LLC organizational type.

[7] Proposed federal tax regulations have been promulgated but to date have not been finalized. Under Proposed Regulation §301.7701-1, 75 Fed. Reg. 55,699 (2010), each series within a series limited liability company agreement would be treated as a separate entity for federal income tax purposes and have its own classification for such purposes (e.g., a partnership, an association taxable as a corporation or disregarded).

[8] For a comprehensive discussion of the subject, see Thomas E. Rutledge, "To Boldly Go Where You Have Not Been Told You May Go: LLC, LLPs, and LLLPs in Interstate Transactions," 58 Baylor L. Rev 205 (Winter 2006).

[9] See Del. Code. Sec. 18-215(c).

[10] At its annual conference meeting in July 2017, the National Conference of Commissioners on Uniform State Laws approved a proposed uniform state law titled the "Uniform Protected Series Act," which is intended to allow assets within an LLC series to be protected from the credit and other liability risks associated with assets owned by such LLC or other LLC series. It remains to be seen how many states will enact series legislation based on the proposed Uniform Protected Series Act.

[11] For additional discussion, see ABA Commercial Law Newsletter, "Secured Lending to Series of LLCs: Beware What You Do Not (and Cannot) Know," Norman M. Powell, Nov. 16, 2015.

[12] Id.

[13] In comparison, in the situation of multiple separate limited liability companies existing under a parent limited liability company, a court would undertake a veil piercing/alter ego analysis to determine if the separate legal existence of the limited liability companies should be disregarded. The factors considered by courts under the veil piercing/alter ego doctrine are often similar to those applied in a substantive consolidation analysis. A detailed discussion of the substantive consolidation doctrine is beyond the scope of this article.

[14] For a detailed discussion of these and related issues concerning the intersection of Article 9 and Series LLCs, see "Dissonance in the Attempt to Harmonize LLC Series and Article 9," Norman M. Powell, UCC Law Journal, Vol. 46 (November 2015).

[15] See UCC Official Text Section 9-307(e).

[16] See UCC Official Text Sections 9-307(b)(2)-(3) .