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Delaware Series Trusts—Separate but Not Equal

by Eric A. Mazie and J. Weston Peterson

Delaware statutory trusts organized in series increasingly are becoming the entity of choice for the formation of investment companies. According to the Investment Company Institute, today there are approximately 9,000 series that have been created within approximately 1,500 registered investment companies organized as Delaware statutory trusts. The popularity of Delaware statutory trusts organized in series in the mutual fund industry stems in large part from the cost savings and administrative efficiencies they provide for the creation and management of multiple funds within a single fund family. Although a common form of fund organization, series trusts can be a source of uncertainty for practitioners, particularly when questions arise as to the legal status of a series under state law; for example, is it the functional equivalent of a separate legal entity?[1] This article attempts to reduce some of the uncertainty by discussing the following topics:

1. The history of the use of trusts organized in series under the Investment Company Act of 1940 (the 1940 Act);
2. The series provisions of the Delaware Statutory Trust Act (the DSTA);
3. The common issues and questions that arise as a result of the use of series; and
4. The future of the series concept under the DSTA.

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Brief History of the Use of Series Trusts as 1940 Act Funds

Investment companies have been organized as trusts (originally Massachusetts business trusts) since at least the early 1920s.[2] At least some of the early investment companies were organized in series prior to the enactment of the 1940 Act, as evidenced by Congress' recognition of them in Section 18(f)(2) of the original 1940 Act.[3] That section excluded shares of a series in a multi-series fund from the prohibition of a fund issuing "senior securities." The continued existence of series investment companies after enactment of the 1940 Act can be traced through actual and proposed amendments to the 1940 Act. For example, in 1967 a bill was introduced in the US Senate that proposed to amend Section 18(f) of the 1940 Act to abolish series investment companies.[4] Congress adopted the amendments in 1970, but ultimately decided to abandon the abolition of series provisions.[5]

Though registered series investment companies have existed for 60 years, it was not until the 1980s that the popularity of the form began to grow. This growth occurred primarily because of the growing popularity of specialty investment funds that put a premium on reducing start-up and administrative costs for funds, and series trusts provided an ideal form.[6] Series trusts can provide substantial savings for multiple fund families by allowing the operation of one multiple series fund instead of creating numerous separate entities. These savings stem from the fact that series trusts often enter into one set of administration and servicing agreements (for example, investment advisor, sub-advisor, custodial, transfer agent, underwriting agreements), as well as the fact that they do not file separate registration statements or prepare separate financial statements.

Series Provisions of the Delaware Statutory Trust Act

Adopted in 1988, the DSTA was originally designed to provide a statutory-based entity for the nascent securitization industry, which theretofore largely had been using common law trusts. When first enacted, the DSTA did not have any provisions recognizing the creation of series. Series provisions were added to the DSTA in 1990 in order to encourage investment companies to organize as statutory trusts in Delaware and to allow them to utilize an internal organizational form already in widespread use in the industry. In fact, the series provisions added in 1990 were initially only available to publicly registered investment companies (a restriction that was eliminated in 1994). The widespread use of the "hub and spoke" and "master-feeder" fund structures has ensured the continued popularity and growth of series trusts.

But what exactly is a series under the DSTA? Answering this question is not altogether straightforward because the DSTA does not define the term "series." In addition, the provisions that permit the creation of series seem to only consider a series to be one of three things:

1. A series of beneficial interests;
2. A series of trustees; or
3. A series of beneficial owners.[7]

Further, the DSTA is largely silent on the rights, powers, and duties that can be associated with a series or the manner of establishment, dissolution, or termination of a series. These subjects largely are left to the terms of the governing instrument. Thus, understanding what a series of a Delaware statutory trust is as a matter of state law necessarily involves a consideration of concepts implicit in the DSTA.

Given that the series provisions of the DSTA were initially enacted specifically for use by public investment companies and that the DSTA states in Section 3806(b)(2) that a "series may have a separate business purpose or investment objective," it seems clear that the series concept is broader than just a series of beneficial owners, trustees, or beneficial interests; that is, there is a broader concept underlying the DSTA provisions. We believe that a series under the DSTA is perhaps best thought of as a pool of segregated assets that is administered for the benefit of a group of equity holders whose rights are limited to those segregated assets and no others; that is, a "series" is the collective of the assets, the system of administration surrounding those assets, and the rights of equity holders associated with such assets. A series can be thought of something like a branch office of a company with the ability to "ring fence" assets and liabilities as discussed below.

Section 3804(a) of the DSTA provides for the ability to limit liabilities of a series such that creditors of one series only have recourse against the assets of that series (and not those of another series or of the trust generally). This ability to limit the liabilities of a series is not an inherent attribute of a series—it is only available to statutory trusts that comply with the requirements of Section 3804(a). Section 3804(a) requires that

the statutory trust must maintain separate and distinct records for each series, and its associated assets must be held and accounted separately from other series and the statutory trust generally.[8] In addition, Section 3804(a) requires that the governing instrument and the certificate of trust (the document that is publicly filed with the Delaware Secretary of State) make appropriate references to the limitation of interseries liability.

By its terms, the interseries limitation of liabilities applies to "the debts, liabilities, obligations and expenses incurred, contracted for or otherwise existing with respect to a particular series." Therefore, the breadth of the statute's reach is broad and not limited to simply contractual liabilities. However, the limitation of interseries liability provided in Section 3804(a) has not been interpreted by any Delaware court, so whether equitable or other exceptions are applicable is unclear.[9] In addition, no Delaware court has had occasion to interpret what form of recordkeeping is required to satisfy the statute's recordkeeping requirements (the SEC recently required an exchange-traded fund to provide a risk factor as to this point).

Common Issues and Questions That Arise with the Use of Series Trusts

The questions under the DSTA as to the nature of a series have ramifications for other areas of the law and raise practical questions as to how series are to be treated in a variety of contexts. Many of these questions revolve around to what extent a series should be considered a separate legal entity (or its functional equivalent). What follows is a summary of the most common questions/issues involving series trusts.

Is a Series of a Delaware Statutory Trust Functionally a Separate Legal Entity?

The question as to what extent a series of an entity is the equivalent of a separate legal entity has become of some interest due to recent amendments to the statutes governing limited liability companies, limited partnerships, and partnerships in Delaware as well as the series provisions of the Illinois Limited Liability Company Act.[10] The series provisions of these statutes either provide series with many of the characteristics of separate legal entities or expressly provide that they should be considered separate legal entities. Some in the mutual fund industry have raised the concern that treating series as separate legal entities, at least in the context of a mutual fund, would be undesirable if it resulted in a change in the way the SEC treated series entities; if they are treated as separate legal entities for all purposes, many of the administrative efficiencies described above could be in jeopardy. As currently drafted, though, this concern is not present under the DSTA. The DSTA neither expressly states that a series is a separate legal entity (as it does with respect to a statutory trust itself[11]) nor grants series many of the characteristics normally associated with separate legal entities, such as the power to sue and be sued, to contract in its own name or hold property in its own name. The foregoing leads the authors to conclude that a series of a Delaware statutory trust is not a separate legal entity and does not possess many of the characteristics often associated with separate legal entities. This is in contrast to the statutes referenced above.

Under the Delaware Limited Liability Company Act (DLLCA), for example, unless its governing instrument provides otherwise, a series of a Delaware limited liability company has the power and capacity, in its own name, to contract, hold title to assets (including real, personal, and intangible property), grant liens and security interests, and sue and be sued.[12] Thus, though not expressly stating that a series of a Delaware limited liability company is a separate legal entity, the DLLCA has provided a series with many of the characteristics of a separate legal entity. Whether there is any practical difference between a series of a Delaware limited liability company and a separate legal entity is not the subject of this article, but clearly it is closer to separate legal entity status than a series of a Delaware statutory trust. Under the Illinois Limited Liability Company Act (ILLCA), however, the question of whether a series of a Illinois limited liability company is the equivalent of a separate legal entity is perhaps beyond debate. Section 37-40(b) of the ILLCA states: "[a] series with limited liability shall be treated as a separate entity to the extent set forth in the articles of organization." The ILLCA currently represents the furthest evolution of the series as a separate legal entity.

Treatment of a Series in Bankruptcy

At least two questions arise in the context of federal bankruptcy law and a series entity. First is the question of whether a petition may be filed by a series separately from the statutory trust of which it is a part or any other series thereof. Second is whether a federal bankruptcy court

will respect the interseries limitation of liability provided by the DSTA. To the knowledge of the authors, no court has provided a definitive answer to either question.

With respect to the ability of a series to file a petition, only a "person" may file a bankruptcy petition under the bankruptcy code, which is defined to include an individual, partnership or corporation but not an estate or trust (other than a business trust[13]).[14] We are not aware of any bankruptcy court that has held that a statutory trust is a "person" but even if it were, whether a series is a person is unclear. To be a person it would have to be "similar enough" to an eligible entity. A series would seem to only share limited liability attributes with corporations and its owners would not have vicarious liability, which is a necessary characteristic for being considered a partnership and thus would not be "similar enough" to either a corporation or a partnership. Should the DSTA's provisions be amended to more closely resemble the provisions of the DLLCA or the ILLCA, the analysis perhaps would be a closer call.

A more practical issue for series trusts is whether or not a bankruptcy court would respect the interseries limitation of liability permitted by the DSTA in all instances. We are not aware of any statutory trusts organized in series having filed for federal bankruptcy protection, so there has not been any guidance on this question. However, bankruptcy courts are courts of equity with broad equitable powers, which include substantive consolidation. Thus it is possible a bankruptcy court could determine the limitation of liability not applicable in certain circumstances.

Treatment of a Series in a Foreign Jurisdiction

Whether a foreign jurisdiction will recognize the limitation of interseries liability provided by Section 3804(a) of the DSTA, if such jurisdiction itself does not have series legislation expressly recognizing internal liability protection, is another open question.[15] Though under general comity principles and the so-called internal affairs doctrine, states will recognize the law of the state of foreign organization as applicable to certain matters (particularly the rights and duties of the owners and managers of the enterprise as between each other), it is not clear that the ring-fencing of liabilities would get the same treatment absent specific statutory authorization.[16] For example, in *Butler v. Adoption Media, LLC*,[17] a California court narrowly read the foreign law recognition provision of the California LLC Act as not applying to disputes that include people or entities that are not part of the LLC, such as creditors.

Miscellaneous Matters

Some other matters in which the treatment of a series of an entity is uncertain:

- *Secured Transactions*: Is a series a "registered organization" within the meaning of Article 9 of the Uniform Commercial Code for purposes of perfecting a security interest?
- *Qualification to Conduct Business*: May a single series apply and obtain certificates of authority to conduct business in a foreign jurisdiction?
- *Taxation*: If the activity of only one series is conducted in a foreign jurisdiction, will that subject the entire entity or just the series to taxation in that jurisdiction?
- *Personal Jurisdiction*: If permitted, does the qualification of a single series in a jurisdiction subject the entire entity to personal jurisdiction in the foreign jurisdiction?
- *Name Registration*: May a series maintain and publicly register a name separate from the entity of which it is a part?

The Future of the Series Concept for Delaware Statutory Trusts

Delaware statutory trusts organized in series have proven to be a popular form of organization for public investment companies. This is due in large part to the flexibility of the DSTA and that its series and certain other provisions were adopted with investment companies in mind and are consistent with how they historically have been organized. However, with the evolution of the series concept in the statutes governing other types of entities both in and outside Delaware, it remains to be seen whether the DSTA provisions will evolve towards the model of a series embodied in the DLLCA or even to that of the ILLCA.

Moreover, from the perspective of investment companies, moving DSTs toward a model where series begin to look or even become indistinguishable from separate legal entities raises a number of perhaps unwanted questions under the current registration and regulatory regime of the SEC, which clearly does not treat a series of a trust as a separate legal entity. Accordingly, it may be best that the series provisions of DSTs

remain aimed primarily to the constituency for which they were originally enacted: investment companies. Perhaps one useful change that could be made would be to make explicit in the DSTA the concept of a series being a segregated pool of assets and liabilities of the trust, which concept is implicit in the DSTA.

NOTES

1. For a discussion of the uncertainties surrounding the treatment of series entities under the Investment Company Act of 1940, *see* Joseph R. Fleming, "Regulation of Series Investment Companies Under the Investment Company Act of 1940," 44 *Bus. Law*. 1179 (1989) [hereinafter Regulation of Series Investment Companies].

2. *See* Sheldon A. Jones, Laura M. Moret, and James M. Storey, "The Massachusetts Business Trust and Registered Investment Companies," *Del. Journal of Corporate Law*, Vol. 13 No. 2 (1988) at 446 [hereinafter The Massachusetts Business Trust].

3. *See* Regulation of Series Investment Companies, *supra* n.1, at 1182.

4. *See* Hearings on H.R. 9510 and H.R. 9511 Before the Subcomm. on Commerce and Finance of House Comm. On Interstate Foreign Commerce, 90th Cong., 1st Sess., pt. 1 at 85 (1967).

5. *See* Regulation of Series Investment Companies, *supra* n.1, at 1182.

6. *See* The Massachusetts Business Trust, *supra* n.2, at 457.

7. *See* Section 3806(b)(1) and (2) of the DSTA. Unlike the Delaware Limited Liability Act or the Delaware Uniform Limited Partnership Act, there is no reference to a series of assets in the DSTA.

8. Section 3804 makes clear that the assets need only be held and accounted for "in such separate and distinct records," *i.e.*, the assets need not be physically segregated but instead can be segregated via book entry.

9. Fraudulent transfer laws and the equitable remedy of substantive consolidation are typically used to reallocate assets in the case of separate legal entities whose creditors have been harmed.

10. To the knowledge of the authors, no Delaware court has addressed the legal standing of a series entity.

11. *See* Section 3801(a) of the DSTA.

12. Section 18-215(c) of the DLLCA.

13. The issue of whether a trust is a "business trust" is itself a question of much debate. *See* In re Secured Equip. Trust of Eastern Airlines, Inc., 38 F.3d 86 (2d Cir. 1994).

14. In addition to enumerated entities, "other similar entities are as well." *See* In re ICLNDS Notes Acquisition, LLC, 259 B.R. 289, 292 (Bankr. N.D. Ohio 2001), which held an LLC eligible because it draws on characteristics of partnerships and corporations.

15. *See* Section 37-40(o) of the ILLCA for an example of a statute expressly recognizing the internal liability protections of a foreign series entity.

16. *See also* GxG Management, LLC v. Young Bros. and Co., Inc., 2007 WL 551761 *8 (D.Me. Feb 21, 2007), for an example of a court grappling with the nature of a series of a foreign series entity.

17. Butler v. Adoption Media, LLC, 2005 WL 2077484 (N. D. Cal. 2005).

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