

Piercing the Veil of an LLC or a Corporation

by Herrick K. Lidstone, Jr.

This article provides an overview of three recent Colorado Court of Appeals decisions regarding piercing the corporate veil of a limited liability company or a corporation. It also discusses relevant provisions of the Colorado Business Corporation Act and the Colorado Limited Liability Act, as well as case law from other jurisdictions.

Piercing the veil of a corporation allows a court to use its equitable powers to hold equity owners liable for the obligations of an entity. Courts make it clear that disregarding the corporate form should be considered a “drastic remedy,”¹ and “corporate veils exist for a reason and should be pierced only reluctantly and cautiously.”²

In 2009, panels of the Colorado Court of Appeals issued two decisions addressing issues related to piercing the veil of a limited liability company (LLC) and a corporation. *Sheffield Services Company v. Trowbridge*³ applied the piercing the veil theory to limited liability companies (LLCs), and *McCallum Family LLC v. Winger*⁴ applied the theory to corporations. Another opinion relating to LLCs, *Colborne Corp. v. Weinstein*,⁵ was issued in 2010. Although *Colborne* does not use the term “piercing the veil,” this opinion also results in the possibility that members may be held personally liable for the debts of an LLC.

In these cases, the respective panels also determined that the theory could be used to hold persons who were not equity owners liable to creditors, although in *McCallum* the panel adopted a theory new to piercing the veil cases and determined that the defendant had “equitable ownership” of the entity and thus could be held liable under a piercing the veil theory. The *Sheffield* and *Colborne* panels reached no such conclusion in holding nonequity owners potentially liable to creditors.

This article provides an overview of the opinions in these three cases. It also discusses certain points regarding the panels’ application of the law to the facts.

Statutory Background

The Colorado Business Corporation Act (CBCA)⁶ and the Colorado Limited Liability Company Act (LLC Act)⁷ specifically protect equity owners from liability. The CBCA states:

Unless otherwise provided in the articles of incorporation, a shareholder or a subscriber for shares of a corporation is not personally liable for the acts or debts of the corporation; except that such person may become personally liable by reason of the person’s own acts or conduct.⁸

Directors and officers of a corporation are held to a standard of care (generally referred to as the business judgment rule⁹ and the duty of loyalty¹⁰), although the CBCA specifically provides that a director’s liability for monetary damages can be limited.¹¹ Section 7-108-401(5) of the CBCA specifically provides that directors and officers have no fiduciary duty to a creditor arising from that person’s status as a creditor.¹² The CBCA also provides that directors—and in some cases shareholders—can be liable for wrongful distributions.¹³

The LLC Act is even more specific in its protection of members and managers of a Colorado LLC. Section 7-80-705 of the LLC Act provides:

Members and managers of limited liability companies are not liable under a judgment, decree, or order of a court, or in any other manner, for a debt, obligation, or liability of the limited liability company.

The LLC Act expresses two exceptions to this statement of non-liability by which members, but not managers, can be expressly liable: § 7-80-107(1)¹⁴ and § 7-80-606(2).¹⁵

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Prior Corporate Cases

Although Colorado had not, prior to *Sheffield*, seen a case for piercing the veil of an LLC, Colorado has seen a number of cases seeking to pierce the veil of a corporation to hold shareholders liable for corporate debt.¹⁶ In the corporate context, the veil may be pierced where the subsidiary is merely an alter ego of the principal or where the corporate shield is being used by shareholders to defraud creditors.¹⁷ In Colorado, the corporate entity may be disregarded and the corporate veil may be pierced “if not doing so would defeat public convenience, justify wrong, or protect fraud.”¹⁸

In *In re Phillips*,¹⁹ the Colorado Supreme Court answered a question certified to it by the U.S. District Court for the District of Colorado and set forth the “three-prong test” to determine whether piercing the corporate veil is appropriate. In reviewing the question, the court must:

- 1) inquire into whether the corporate entity is the alter ego of the shareholder;²⁰
- 2) inquire whether justice requires recognizing the substance of the relationship between the shareholder and corporation over the form because the corporate fiction was used to perpetrate a fraud or defeat a rightful claim; and
- 3) evaluate whether an equitable result will be achieved by disregarding the corporate form and holding the shareholder personally liable for the acts of the business entity.

*LaFond v. Basham*²¹ is a 1984 case where a Colorado Court of Appeals panel applied a piercing the corporate veil theory to hold a corporate director personally liable to creditors where the court determined that equity required.²² In *LaFond*, the facts were clear that the director, Basham, did not own stock in the corporation in question

but, as president and general manager, he clearly dominated both his wife and son, the only stockholders, insofar as corporate policy, activities, funds, and other corporate matters were concerned. In fact, Basham testified, “The rule was, that I owned the corporation. . . .”²³

When the corporation was insolvent, Basham demanded and received payment of obligations to him to the detriment of other creditors. Because of Basham’s preferential payments to himself, the court of appeals found him liable for those payments under a piercing the veil theory.²⁴ In referring to the *La Fond* decision, the Honorable John W. Madden stated that “[t]he ruling may have been driven by the particular facts of the case” rather than by the law.²⁵

The Law in Other Jurisdictions

Several other jurisdictions have addressed the question of piercing the veil of an LLC, in each case finding that the target of piercing the veil also must be a member. The U.S. District Court for the District of Oregon stated that it would allow the piercing of the limited liability veil of an LLC where:

- 1) the defendant member controlled the debtor;
- 2) the defendant member engaged in improper conduct; and
- 3) as a result of the improper conduct, the plaintiff either entered into a transaction that it otherwise would not have entered into, or the plaintiff was not able to collect a debt against an insolvent entity.²⁶

In that case, the court found that the defendant, who was the sole manager and member, clearly controlled the LLC. The court

also found “improper conduct” where there was “commingling assets and a general disregard of [the LLC’s] form and status as a separate legal entity.”²⁷ The trial court could not determine the third factor on motions and left it for determination at trial.²⁸

In another case, the Delaware Chancery Court indicated that the circumstances necessary to pierce the veil of an LLC must be pervasive. According to the court, that means that the circumstances do not stem merely from a single transaction.²⁹

In a detailed Second Circuit Court of Appeals decision discussing the piercing of a veil of a Delaware LLC,³⁰ the plaintiffs sought to hold the sole member of the LLC liable for breach of contract by the LLC on the basis that the member was the LLC’s alter ego. The trial court granted summary judgment in favor of the member on the ground that the plaintiffs had not set forth sufficient evidence to pierce the veil of the LLC. The Second Circuit discussed Delaware corporate veil piercing principles and concluded that such principles are generally applicable to an LLC.

In reaching the conclusion that the defendant was not entitled to summary judgment, the court examined the evidence that the LLC and its sole member operated as a single entity and found that the evidence, viewed most favorably to the plaintiffs, showed:

- Lack of corporate formalities. Although corporate veil piercing principles are generally applicable to an LLC, somewhat less emphasis should be placed on whether the LLC observed internal formalities in an alter ego analysis of an LLC. However, if two entities with common ownership “failed to follow legal formalities when contracting with each other[,] it would be tantamount to declaring that they are indeed one in the same.”³¹
- Inadequate capitalization. The LLC was started with a capitalization of no more than \$20,100, and then proceeded to invest millions of dollars supplied by its member.³²
- Treating the LLC’s funds as if they were the member’s funds. The member put money into the LLC as needed and took money out as the member needed it.
- Lack of financial segregation with other entities. The LLC had only one officer other than its member, and the officer was paid by the member or one of his corporations. The LLC shared space with other companies owned by the member and shared employees with the member or other companies owned by the member with no accountability.
- Lack of independent decision making. The member formed the LLC to be used as an investment vehicle for him to make investments, and the ultimate decisions were always made by the member.
- Personal use of LLC funds. The court reviewed evidence relating to financial transactions involving the LLC, including:
 - the LLC made transfers to the member or third parties on his behalf in connection with living expenses
 - the individual in charge of the LLC’s financial records testified that the member made the decision to treat monies deposited into the LLC as loans, so that the member could make withdrawals as he needed money without having to pay taxes on the money withdrawn
 - the loans were not evidenced by written agreements, and there were no set repayment programs or terms.

The Second Circuit concluded that this evidence was ample to permit a reasonable fact finder to determine that the member completely dominated the LLC and treated its bank account as one of

his pockets. The court then reviewed evidence relating to fraud, illegality, or injustice and stated that there may be overlap in the proof offered to show that the LLC and its member operated as a single entity and in the proof relating to unfairness.

The court pointed out that the member's withdrawal of monies from the LLC would be properly characterized as distributions if the payments to the LLC were capital contributions, and that distributions to the member may well have violated the prohibition on distributions under the Delaware LLC statute, given that the LLC had ceased operating and was unable to pay its debt to the plaintiffs. The court stated that a fact finder could infer that the member's payments to the LLC were deliberately mischaracterized as loans to disguise the fact that the member was making withdrawals prohibited by law.

The court also stated that a reasonable fact finder could find that the member operated the LLC in his own self-interest in a manner that unfairly disregarded the rights of the LLC's creditors, given various payments and withdrawals on the member's behalf at a time when the LLC was unable to pay its debt to the plaintiffs, as well as evidence that the member withdrew more money from the LLC than he put into it. The court concluded by finding that neither the LLC member nor the plaintiffs were entitled to summary judgment on the veil piercing claim.

The issues may be treated differently for tort liability versus contract liability. Where a plaintiff suing on a contract knows that it is dealing with an entity and fails to ensure that the entity is adequately capitalized, it may be precluded from asserting a piercing the veil claim.³³ Nationally, a number of lower courts have ad-

ressed the question of piercing the veil of an LLC and have generally concluded that the:

plaintiff bears "a heavy burden of showing that [the LLC] was dominated as to the transaction attacked and that such domination was the instrument of fraud or otherwise resulted in wrongful or inequitable consequences."³⁴

The *Sheffield v. Trowbridge* Opinion

The facts of *Sheffield Services Company v. Trowbridge* are complex and involve the actions of two LLCs—Colfax Industrial, LLC (Colfax) and Villa Ventures, LLC (Villa).³⁵ Because the trial court failed to determine whether an individual, Charles A. Trowbridge, was a member or manager of Villa, most of the *Sheffield* panel's decision deals with Trowbridge's status as a manager but not a member of Colfax.

Colfax and Villa each had obligations under a 1998 development agreement with the City and County of Broomfield.³⁶ The two LLCs failed to meet their obligations to Broomfield and Broomfield declared a breach.³⁷

Sheffield and Colfax entered into an agreement on April 21, 2004, by which Sheffield agreed to purchase the lots in the subdivision owned by Colfax; Sheffield entered into another contract by which it agreed to purchase other lots owned by Villa. The Colfax contract at issue in the appeal contained certain representations and warranties by Colfax as to its compliance with the Development Agreement and the fact that the lots being purchased were "finished and fully developed," which representations and warranties were untrue when made and were still untrue at the clos-

ing on June 30, 2004. As manager of Colfax, Trowbridge signed the Sheffield–Colfax agreement and the subsequent closing documents.

There was substantial testimony at trial that representatives of Sheffield knew about the difficulties between Colfax (and Villa) and Broomfield. Sheffield admitted that it was a sophisticated investor as to real estate transactions with significant experience in housing development, and that it had held meetings with Broomfield personnel who stated that the LLCs' obligations under the Development Agreement were not complete. Sheffield testified that, based on its experience, it knew that Broomfield could withhold building permits if the developer did not comply with the obligations of the Development Agreement.³⁸ Ultimately, Sheffield brought suit against Colfax and Villa for breach of contract, and recovered damages of \$190,008.53.

From here, the facts become complicated. The trial court found that Trowbridge was a manager of Colfax, but not a member. Colfax had only two members: Trowbridge Agency and Dr. Ron Yaros (each with 50 percent). Neither member was a party to the action. The court found that the Trowbridge Agency was owned by Trowbridge's wife but acted "at the direction of Defendant Trowbridge."³⁹

Trowbridge owned another entity, Krystal Custom Homes, LLC (Krystal), which owned various water and sewer taps. As part of the closing between Sheffield and Villa, Krystal agreed to transfer ten water and sewer taps to Sheffield for \$26,101 per tap. Sheffield was obligated to pay for only five of these taps, and received the other five for no further payment.⁴⁰ The trial court noted that Krystal (which was in foreclosure at the time for unrelated debts) obtained no known benefit from the sale of its water taps, because Sheffield made payment for the taps to the operating account of Trowbridge Agency for the benefit of Villa, not to Krystal.⁴¹

Another complicating factor was that in November 2003, Trowbridge and Yaros entered into several instruments intended to document several "loans" made by Yaros to Colfax. The related deed

of trust was never recorded, and the trial court concluded that this was an effort to

shelter [Yaros] from creditors' claims by changing the nature of his contributions and by giving him preferential treatment to the extent that he was a creditor of the limited liability company.⁴² On July 2, 2004 (two days after the Colfax–Sheffield closing),⁴³ the Trowbridge Agency, on behalf of Colfax, paid Yaros \$500,000 as a loan repayment and \$45,000 as an expense reimbursement.⁴⁴

The trial court found that Colfax

did not hold any membership meetings, keep any minutes of meetings or documents clearly ratifying activities of the managers, never set forth the amount of the financial contribution of the members, and failed to maintain any bank accounts for the purposes of conducting company business. These items were required by the operating agreement or Colorado law.⁴⁵

All payments for Colfax and Villa, including the payments to Yaros, were made out of the Trowbridge Agency Sales Escrow Account. The trial court noted this fact and stated:

When combined with the direct payments made to the Trowbridge Agency at Defendant Trowbridge's direction for the assets of Krystal . . . it is clear to the Court that the complicated, interrelated and commingled financial circumstances of the Defendant Trowbridge and his various business entities was intended to frustrate the creditors of each.⁴⁶ [The trial court found that t]his entire factual pattern demonstrates complicit conduct intended to provide the manager and one member, the Trowbridge Agency, plausible deniability intended to insulate preferential distributions to another member. The fair inference to be drawn from the overall conduct is that there was a clear financial benefit to the Defendant Trowbridge, although perhaps not documented, from this elaborate scheme of concealment."⁴⁷

Finally, the trial court also concluded that "the level of control that Defendant Trowbridge maintained over the multiple limited liability companies' assets, using them interchangeably to meet his needs, is highly unusual."⁴⁸

Notwithstanding these findings, the trial court concluded that Trowbridge should not be held personally liable to Sheffield. The trial court identified the question as follows:

The critical issue before the Court is, under the totality of the circumstances of this case, whether personal liability attaches to a manager where the manager directs the dispersal of assets to a joint member of a limited liability company that renders the entity insolvent to the detriment of a known contingent creditor.⁴⁹ In reaching the conclusion that Trowbridge had no personal liability to Sheffield, the trial court noted that the liability provisions of the LLC Act extend to members, not managers, and that the members of Colfax were not parties to the case.⁵⁰

The Court of Appeals' Decision

In its decision, the *Sheffield* panel reversed the trial court on the question of Trowbridge's personal liability. Notwithstanding the plain language of CRS § 7-80-705,⁵¹ the *Sheffield* panel referred to CRS § 7-80-107(1) and concluded:

The General Assembly did not expressly, or by clear implication, manifest an intent to prohibit courts from using the common law piercing the corporate veil doctrine to hold an LLC manager personally liable for the LLC's improper actions.⁵²

The *Sheffield* panel also cited *LaFond v. Basham*⁵³ for further authority that the court may extend the piercing the corporate veil doctrine beyond corporate shareholders to hold corporate directors "personally liable if equity so requires."⁵⁴ The *Sheffield* panel stated:

Whether the conduct in question is that of a corporate director, as in *LaFond*, or an LLC manager, as in this case, the injustice wrought by adherence to the corporate or LLC fiction is the same: the director's or manager's actions in using corporate or LLC assets for personal gain would defeat a creditor's valid claim.⁵⁵

To support its conclusion, the *Sheffield* panel also cited *Alexander v. Anstine*.⁵⁶ The *Anstine* decision described the common law obligation of officers and directors of a corporation to creditors as follows:

Under the common law, when a corporation becomes insolvent, a duty arises in its directors and officers to the corporation's creditors. It has been said that directors and officers of an insolvent corporation are "trustees" for the corporation's creditors. The trustee role with regard to creditors does not encompass the full set of fiduciary duties owed by directors and officers to shareholders of a solvent corporation. Rather, it is a limited duty that requires officers and directors to avoid favoring their own interests over creditors' claims.⁵⁷

In *Anstine*, the Supreme Court noted that the Colorado Legislature adopted CRS § 7-108-401(5) directly in response to the court of appeals' earlier decision in that case, but specifically expressed "no opinion on whether [CRS § 7-108-401(5)] applies where a corporation is insolvent."⁵⁸ As discussed in the next section, it is not clear that the *Anstine* analysis has survived the legislative action enacting § 401(5) notwithstanding the rulings of the *Sheffield*, *Colborne*, and *McCallum* panels.

The Colborne Corporation v. Weinstein Opinion

In January 2010, a different panel of the Colorado Court of Appeals decided *Colborne Corporation v. Weinstein*.⁵⁹ There, the trial

court had dismissed a complaint for failure to state a claim against members of an LLC who allegedly received distributions that rendered the LLC insolvent.

The facts in the court of appeals' decision are sparse and, on a motion to dismiss, the court assumes that the facts as alleged by the plaintiffs are true, although the court can make its own legal analysis. The Boulder Partnership, LLC (Boulder) had two corporate managers. The two corporate managers each had a single shareholder (Major and Weinstein), and these individuals were the only members of Boulder. Boulder owed Colborne more than \$200,000. Colborne alleged that Weinstein and Major (through the corporate managers each controlled) authorized Boulder to pay the members (themselves) distributions that rendered Boulder insolvent, in violation of CRS § 7-80-606. Colborne also alleged that they had violated the *Anstine* duty. The trial court determined that Colborne did not have standing to sue under § 606 and the common law duty approved by *Anstine* did not apply to LLCs.

CRS § 7-80-606(1) provides that an LLC shall not make distributions to its members if the distribution would render the LLC insolvent. Section 606(2) provides that a member who receives a distribution in violation of subsection (1)

and who knew at the time of the distribution that the distribution violated subsection (1) of this section, shall be liable to the limited liability company for the amount of the distribution" (emphasis supplied).

The panel reviewed cases under the Colorado Corporation Code (CCC) (repealed as of July 1, 1994) and the CBCA to determine

that, notwithstanding the provisions of the CBCA⁶⁰ and the prior CCC providing for directors' liability "to the corporation" for wrongful distributions, courts have interpreted this to give creditors standing to sue in the corporation's stead and the panel believed that this analysis should extend to LLCs under § 606.

The principal case cited by the *Colborne* panel for this proposition was *Ficor, Inc. v. McHugh*,⁶¹ decided under § 7-5-114(3) of the CCC. (The current language in § 7-108-403 of the CBCA is almost identical.) In reaching its conclusion that creditors could bring an action against directors for approving unlawful distributions, notwithstanding the statutory language that makes it clear only the corporation has the right to bring an action, the *Ficor* court said:

We first note that the purpose behind section 7-5-114(3) is the protection of creditors. . . . Indeed, since the corporate existence is terminated, . . . the only reason to permit recovery by the corporation is so that it may utilize the monies to satisfy the unpaid creditors. . . . The remaining question is whether all creditors of a corporation, as a group, may assert this remedy on behalf of the corporation for their own benefit. Since the statute is for the purpose of protecting creditors, and limitation of the remedy to the corporation is only to ensure that all creditors are treated equally, we conclude that such an action can be brought [by the creditors].⁶²

Citing *Sheffield*, which was decided after the trial court decision in *Colborne*, and relying on *Ficor*, the *Colborne* panel concluded "that creditors of an LLC, as a group, have standing to sue an LLC member who knowingly receives an unlawful distribution pursuant to section 7-80-606." The statute speaks only to the right of the LLC to do so.

The panel also reversed the trial court's dismissal of *Colborne's* other claim that the managers violated their "limited fiduciary duty" to creditors of an insolvent corporation. The *Colborne* panel's decision reinstating that claim was based on *Anstine*, but did not discuss the Supreme Court's footnote 9 in *Anstine*⁶³ or whether the theory survived the adoption of CRS § 7-108-401(5).

The *Colborne* panel discussed statutory history of the CCC and the CBCA and the 1990 adoption of the LLC Act. However, it did not discuss the fact that the legislature adopted § 7-108-401(5) expressly to address the court of appeals' decision in *Anstine*. The *Colborne* panel also did not discuss *Anstine's* footnote 9, which left open for further analysis the question of the applicability of the statute in insolvency.

CRS § 7-108-401(5) (added to the CBCA by Senate Bill 2006-187) expresses the legislature's intention to limit creditor recourse to directors, officers, and shareholders of a corporation. At the same time, the legislature went further to limit creditors' recourse to the owners and managers of an LLC when it amended the LLC Act to repeal § 7-80-607 (which provided six-year liability for any member who received an unlawful distribution) and to amend § 7-80-606 to impose liability only to members who knew the distribution was in violation of the statute and to reduce the liability from six to three years.

Thus, contrary to the court of appeals' findings in *Sheffield* and *Colborne*, the legislature has spoken in a clear manner intentionally limiting the rights of creditors against not only management of corporations and LLCs, but also against the equity owners. In the 2006 amendments to the CBCA and the LLC Act, the legislature spoke clearly and in a manner contrary to the Supreme Court's *Ficor* and the Court of Appeals' *Anstine* decisions.

The McCallum Family LLC v. Winger Opinion

The facts of the *McCallum* case are similar to those in *LaFond* and (unlike *Sheffield* and *Colborne*) involve the piercing of a corporate veil.⁶⁴ Although Marc Winger (Marc) was not a shareholder, an officer, or a director of the corporation (Manitoba), like Basham, Marc was a corporate insider who "essentially functioned as an owner," and "managed the whole affair." The two shareholders of Manitoba were his wife and his mother (Karen), and "neither of the nominal shareholders properly supervised his activities."

Furthermore, Marc

took a number of “distributions” from Manitoba even though he was not a shareholder [and he] routinely used corporate funds to pay personal bills for himself and his wife, including payment of his California sales tax obligation and outlays for a boat, cell phone, and personal credit cards.

The court of appeals adopted a new theory—the “equitable ownership” doctrine—and ruled that an individual who acts as a *de facto* shareholder, officer, or director may be treated as an equitable owner and held to be the alter ego of a corporation.⁶⁵

The *McCallum* trial court had held that piercing the veil against one who was not an equity owner was inappropriate. By determining that Marc was the equitable owner and alter ego of Manitoba, the *McCallum* panel found Marc liable under a piercing the corporate veil theory.⁶⁶

In considering the veil piercing claim, the panel applied the three-prong test established by the Colorado Supreme Court in *In re Phillips*, which is discussed above.⁶⁷ Under the first prong, the panel determined that Marc used the corporation as his alter ego, as evidenced by numerous instances of Marc’s own disregard of the corporate formalities and personal use of corporate funds. The panel concluded that the “undisputed evidence showed that the corporation lacked ‘economic substance.’” The panel significantly extended Colorado’s veil piercing law by expressly adopting the equitable ownership doctrine and applying the doctrine to hold that a corporate insider such as Marc, who is not a formal shareholder, officer, or director, can be the alter ego of a corporation.

In considering the second prong, the panel noted that “[t]he mere fact that corporate creditors would go unsatisfied because they cannot reach a shareholder’s personal assets does not, alone, justify piercing the corporate veil.”⁶⁸ The *McCallum* panel determined that to satisfy the second prong, a creditor seeking to pierce the veil must show “either fraud or that the corporate form was abused to defeat the rightful claims of creditors. There is no additional requirement to prove any conduct specifically directed at the plaintiff-creditor.” The *McCallum* panel went on to say that the creditor “must show an *effect* on its lawful rights as a creditor resulting from abuse of the corporate form.”⁶⁹

Based on Marc's actions that "removed all available corporate funds" from Manitoba, the *McCallum* panel determined that the second prong was met without requiring an additional showing that his actions were specifically directed at defeating the creditor's rights.

The *McCallum* panel determined that the trial court had not reached consideration of the third prong—equity—and remanded the case to the trial court for consideration of this prong. The *McCallum* panel directed the trial court to inquire "whether 'an equitable result will be achieved by disregarding the corporate form and holding the shareholder personally liable for the acts of the business entity.'"

The *McCallum* panel mentioned CRS § 7-108-401(5) in another part of the opinion dealing with Karen's potential liability, but that section did not figure into the panel's conclusion.⁷⁰ Karen was a director, officer, and 50 percent shareholder of Manitoba. By stipulation, the parties agreed that Manitoba was insolvent by September 2004. The panel noted that Manitoba paid Karen (as a shareholder) a distribution before the September 2004 insolvency date. Because the payment predated insolvency, the panel concluded that it did not disadvantage creditors to Karen's benefit.

In reaching this conclusion, the panel focused on the dividend that Karen received and did not focus on the fact that Karen was a director and officer of Manitoba at the time Manitoba paid Marc distributions after the September 2004 determination of insolvency to the detriment of Manitoba's creditors—the intended object of CRS §§ 7-108-403 and -401(5). If Karen participated in the approval of those distributions to Marc, and if it could have been shown that she directly or indirectly benefitted as a result of the distributions to her son, Karen would have violated her *Anstine* duty (to the extent it survived the adoption of § 7-108-401(5)).

Conclusion

In the past, the courts have made it clear in Colorado and elsewhere that disregarding the corporate form should be considered a "drastic remedy,"⁷¹ rather than a remedy that should be applied where the court is unable to find another basis for providing a creditor relief. In all three cases discussed above, it appears that the management attempted to disenfranchise creditors to the benefit of the equity owners or management itself. Management of the three entities involved in *Sheffield*, *McCallum*, and *Colborne* clearly sought to favor themselves over the interests of creditors and the court of appeals panels used the court's equitable powers to find liability where the courts were unable to do so through a strict interpretation of the applicable statutes.

The ultimate effect of a continuing application of the doctrine as applied by the *Sheffield* and *Colborne* panels might raise concern about whether Colorado LLCs can protect their owners and managers from liability, not only in outrageous transactions as seen in *Sheffield* and *Colborne*, but in other transactions, as well. This may result in Colorado becoming a less-attractive jurisdiction in which to form LLCs.

Notes

1. Eismeier and Dindinger, "The Alter Ego Doctrine in Colorado," 28 *The Colorado Lawyer* 53 (March 1999), citing *Skidmore, Owings & Merrill v. Canada Life Assurance Co.*, 907 F.2d 1026, 1027 (10th Cir. 1990) (applying Colorado law).

2. *Boughton v. Cotter Corp.*, 65 F.3d 823, 836 (10th Cir. 1995) (applying Colorado law). See also *Liberty Property Trust v. Republic Properties Corp.*, 577 F.3d 335, 340 (D.C. Cir. 2009) ("Piercing the corporate veil 'is a step to be taken cautiously.'") (citation omitted.) See Madden, "Piercing

Practice Pointers: How to Avoid Piercing the Veil

- Do not use the entity to assist the principals in lying, cheating, or stealing. Under the old legal maxim of "bad facts make bad law," a court might ignore the law where the judge believes that equity demands relief.
- Maintain formalities where possible. Formalities (including minutes) are required of corporations, but are advisable with LLCs even though the LLC Act states that a failure to observe formalities relating to management "is not in itself a ground for imposing personal liability on members." CRS § 7-80-107(1). Formalities are required in an LLC where the operating agreement so states.
- Have management manage. The CBCA and the LLC Act impose certain obligations on the persons designated to manage the entity. Where managerial rights are assumed by non-managers (as in *McCallum*), a court is more likely to be convinced that the form of the entity should be disregarded.
- Provide for financial segregation and do not allow personal use of entity funds. Even in the case of a single-member LLC, the entity should have its own tax identification number and its own bank accounts, which are identified and used for business expenses. Where entity funds are used for personal expenses, a court is more likely to be convinced that the form of the entity should be disregarded. Where related entities share lease space or management, appropriate arrangements should be documented and followed.
- Ensure that the entity is adequately capitalized for its intended business. Where there are excessive amounts of debt compared to a nominal amount of capital (and especially where the debt is "inside debt" to the managers or their affiliates and friends), a court is more likely to be convinced that the form of the entity should be disregarded.
- Where there are loans, ensure that they are timely and properly documented and that they are treated in accordance with the documentation. Where the entity and its managers ignore the contractual requirements for a loan, a court also may be inclined to do so.
- Where an LLC is established as a single-purpose entity (SPE) for a financing transaction, the creditors may want to pay attention to the contractual internal controls to prevent the SPE from filing a bankruptcy petition at the parent's demand and to provisions defining the duties of the independent manager.
- Recognize that there still is significant doubt as to the entity's manager's duties to creditors in the zone of insolvency, notwithstanding statutory guidance to the contrary. At the very least, pay attention to the *Anstine* guidance that entity managers should avoid favoring their own interests over creditors' claims.

the Corporate Veil,” in *The Practitioner’s Guide to Business Organizations* (Reichert and Rozansky, eds.) ch. 32 at 32-1 (CBA Supp., 2008), citing *Leonard v. McMorris*, 63 P.3d 323, 330 (Colo. 2003) (“Courts have held that only extraordinary circumstances justify disregarding the corporate form to impose personal liability.”).

3. *Sheffield Services Company v. Trowbridge*, 211 P.3d 714 (Colo.App. 2009). No petition for *certiorari* was filed.

4. *McCallum Family LLC v. Winger*, 221 P.3d 69 (Colo.App. 2009).

5. *Colborne Corporation v. Weinstein*, ___ P.3d ___, 2010 WL 185416 (Colo.App. 2010).

6. CRS §§ 7-101-101 *et seq.* (Colorado Business Corporation Act (CBCA)).

7. CRS §§ 7-80-101 *et seq.*

8. CRS § 7-106-203(2).

9. Described in CRS § 7-108-401.

10. Described in CRS § 7-108-501.

11. CRS § 7-108-402.

12. CRS § 7-108-401(5), added by amendment to the CBCA in 2006 following a court of appeals determination that directors and officers did owe a fiduciary duty to creditors in certain circumstances. *Anstine v. Alexander*, 128 P.3d 249 (Colo.App. 2005). The Colorado Supreme Court, in *Alexander v. Anstine*, 152 P.3d 497, 498 (Colo. 2007), stated that this fiduciary duty did not exist, but directors and officers of “an insolvent corporation owe creditors a duty to avoid favoring their own interests over creditors’ claims.” The Court referred to this not as a fiduciary duty, but as a “limited trustee duty.” The Court expressed “no opinion on whether [the 2006 amendment] applies where a corporation is insolvent.” *Id.* at 502, n.9.

13. CRS § 7-108-403(1). A director can seek contribution from shareholders who received the distribution “knowing the distribution was made in violation of section 7-106-401.” Shareholders may be liable to creditors of a dissolved corporation for (but not more than) the amount of any liquidating distribution received. CRS § 7-90-913.

14. CRS § 7-80-107(1) provides that members of a limited liability company (LLC) may be held liable under a piercing the veil theory for alleged improper actions of the LLC in accordance with the case law applicable to corporations. This section further states that a failure to observe formalities relating to management “is not in itself a ground for imposing personal liability on members. . . .”

15. CRS § 7-80-606(2) provides that members who receive a distribution made in violation of § 7-80-606(1) and who knew that the distribution violated that section “shall be liable to the limited liability company for the amount of the distribution.”

16. See Eismeier and Dindinger, *supra* note 1 (discussion of piercing the corporate veil in Colorado and its historical development). See also Madden, *supra* note 2.

17. See *Fish v. East*, 114 F.2d 177 (10th Cir. 1940).

18. *Great Neck Plaza v. LePeep Restaurants*, 37 P.3d 485, 490 (Colo.App. 2001).

19. *In re Phillips*, 139 P.3d 639, 644 (Colo. 2006). See also *Skidmore, Owings & Merrill*, *supra* note 1 at 1027 (ten-factor test established by the Tenth Circuit Court of Appeals, interpreting Colorado law); *Fish*, *supra* note 17 (classic test for piercing the corporate veil to hold a shareholder liable for corporate obligations, also interpreting Colorado law).

20. Among the factors that the *McCallum* panel said should be considered in reaching a conclusion that the corporation was the alter ego of the defendant were the following: (1) the corporation is operated as a distinct business entity; (2) funds and assets are commingled; (3) adequate corporate records are maintained; (4) the nature and form of the entity’s ownership and control facilitate misuse by an insider; (5) the business is thinly capitalized; (6) the corporation is used as a “mere shell”; (7) legal formalities are disregarded; and (8) corporate funds or assets are used for noncorporate purposes. 2009 WL 3465332 at *3.

21. *LaFond v. Basham*, 683 P.2d 367 (Colo.App. 1984).

22. *Sheffield*, *supra* note 3 at 721.

23. *LaFond*, *supra* note 21 at 369.

24. *Id.* at 369-70. The court could have treated Basham as an equity owner based on his statements, but that was not expressed as a basis for the court’s decision.

25. Madden, *supra* note 2 at 32-5.

26. *BLD Products LTC v. Technical Plastics of Oregon, LLC*, No. 05-556-KI, 2006 WL 3628062 *4 (D.Or. Dec. 11, 2006).

27. *Id.* at *5.

28. *Id.* at *6.

29. *In EBG Holdings LLC v. Vredeszicht’s Gravenhage*, 109 B.V., No. 3184-VCP, 2008 WL 4057745 (Del.Ch. Sept. 2, 2008), a Delaware LLC sued one of its members, a Dutch LLC (VG 109), and the member’s parent corporation (NIBC), seeking a declaration that VG 109 was NIBC’s alter ego, as well as specific performance of provisions of the LLC agreement, among other things. The court found that there was not a sufficient showing of fraud or other inequity to disregard the NIBC corporate form. The court pointed out that the fraud or injustice must stem from an inequitable use of the corporate form itself, not merely from the underlying cause of action for breach of contract. The court found that a conclusory statement in the complaint that NIBC knowingly used VG 109 as an instrument to shield itself from liability for tax obligations related to ownership in the LLC and was insufficient to support a reasonable inference that NIBC’s use of VG 109’s limited liability status was fraudulent or inequitable. There also was no showing that VG 109’s capitalization was so minimal as to prove it was a sham entity.

30. *NetJets Aviation, Inc. v. LHC Communications, LLC*, 537 F.3d 168 (2d Cir. 2008).

31. *Id.* at 178. The Colorado LLC Act states that a failure to observe formalities relating to management “is not in itself a ground for imposing personal liability on members.” CRS § 7-80-107(1).

32. Commentators have stated that veil piercing for inadequate capitalization is less likely for LLCs than for corporations, because there exists express statutory authority in the LLC Act for withdrawal of funds from failing firms—and consequently, creditors are able to assess risk and accordingly adjust credit terms for undercapitalized LLCs. Ribstein and Keatinge, *Ribstein and Keatinge on Limited Liability Companies* § 12.3 (2d ed., Thompson/West, Supp., 2006).

33. See *Marina, LLC v. Burton*, No. CA 97-1013, 1998 WL 240364 *7 (Ark.App. May 6, 1998).

34. *Retropolis, Inc. v. 14th Street Development LLC*, 797 N.Y.S.2d 1, 2 (N.Y.A.D. 1 Dept. 2005). For undercapitalization to justify piercing the veil, “it must be coupled with evidence of an intent at the time of capitalization to improperly avoid future debts of the [LLC].” *Milk v. Total Pay and HR Solutions, Inc.*, 634 S.E.2d 208, 212 (Ga.App. 2006). See also *Morris v. Cee Dee, LLC*, 877 A.2d 899 (Conn.App. 2005), *certification granted in part*, 883 A.2d 1245 (Conn. 2005); *Lily Transp. Corp. v. Royal Institutional Servs., Inc.*, 832 N.E.2d 666 (Mass.App. 2005), *review denied*, 836 N.E.2d 1096 (Mass. 2005); *Pinebrook Properties, Ltd. v. Brookhaven Lake Property Owners Ass’n*, 77 S.W.3d 487 (Tex.App. 2002).

35. The following facts are derived in large part from the Amended Order issued on November 27, 2007 by the Honorable Chris Melonakis, of the District Court for the City and County of Broomfield, in Case No. 06CV236 (Amended Order).

36. The Development Agreement required that certain infrastructure, landscaping, and other improvements be completed and approved prior to the issuance of any building permits or certificates of occupancy. Amended Order, *supra* note 35 at 2.

37. *Sheffield*, *supra* note 3 at 717.

38. *Id.* at 725. Trowbridge and the other manager, Mason, did withhold from Sheffield a letter they received two weeks before the closing, in which Broomfield stated that it would withhold building permits if Colfax and Villa failed to comply with the Development Agreement. *Id.* at 717-18.

39. Amended Order, *supra* note 35 at 7, 23.

40. *Id.* at 6.

41. *Id.* at 7.

42. *Id.* at 10.

43. *Id.* at 22. The district court states “two days after closing,” but refers to 2007, not 2004. On page 5, it refers to May 3, 2007 as preceding May 14, 2004.

44. The district court noted the expense reimbursement was unusual where the testimony was that Yaros “was not actively involved with [Colfax]” and “the Court finds that the reimbursement entry further undermines the creditability of Defendant Trowbridge’s testimony and reinforces the Court’s prior findings and conclusions regarding the nature of Yaros’s contribution and distributions made to him.” *Id.* at 22.

45. *Id.* This shows the danger of a specific operating agreement requirement for meetings and minutes—matters that are not required by the LLC Act.

46. *Id.* at 23.

47. *Id.* at 24.

48. *Id.* at 7.

49. *Id.* at 25.

50. *Id.* at 26-27.

51. “Members and managers of limited liability companies are not liable under a judgment, decree, or order of a court, or in any other manner, for a debt, obligation, or liability of the limited liability company.”

52. *Sheffield*, *supra* note 3 at 719. *See also id.* at 720, which states: “Therefore, we conclude that the plain language of section 7-80-107(1) does not prohibit a court from applying the equitable common law doctrine of piercing the corporate veil to hold an LLC manager personally liable for the LLC’s improper actions.”

53. *LaFond*, *supra* note 21.

54. *Sheffield*, *supra* note 3 at 721.

55. *Id.* The *Sheffield* panel went on to refer to the district court’s finding on page 24 of the Amended Order where the district court said: “The fair inference to be drawn from the overall conduct is that there was a clear financial benefit to the Defendant Trowbridge, although perhaps not documented, from this elaborate scheme of concealment.” *Sheffield*, *supra* note 3 at 722. To clarify this issue, one of the *Sheffield* panel’s directions to the district court on remand was to determine “whether Trowbridge breached the common law duty of an LLC manager to avoid favoring personal interests over the LLC’s creditors’ claims.”

56. *Anstine*, *supra* note 12, *cited at Sheffield*, *supra* note 3 at 723.

57. *Anstine*, *supra* note 12 at 502 (citations omitted).

58. *Id.* at 502, n.9. *See* discussion of CRS § 7-108-401(5), *supra* note 12.

59. *Weinstein*, *supra* note 5.

60. CRS § 7-108-403(1).

61. *Ficor, Inc. v. McHugh*, 639 P.2d 385, 393 (Colo. 1982). The *Sheffield* and *McCallum* panels also relied on *Ficor, Inc. v. McHugh*.

62. The panel also cited *Paratransit Risk Retention Group Ins. Co. v. Kamins*, 160 P.3d 307 (Colo.App. 2007) to support a creditor’s right to sue under CRS § 7-108-403.

63. In *Anstine*, the Supreme Court noted the adoption of CRS § 7-108-401(5) but in footnote 9 expressed “no opinion on whether [§ 7-108-401(5)] applies where a corporation is insolvent.”

64. *McCallum*, *supra* note 4.

65. *Id.* at 77.

66. *Id.* at 76-77. The *McCallum* panel held:

We conclude that an individual should not be able to defeat the alter ego prong of the veil-piercing analysis merely because he or she has no formal ownership interest in the corporation, and does not hold the title of officer or director. The proper inquiry is into the substance of the corporation’s governance as well as its form.

67. This is discussed in the narrative at notes 19-20. As discussed above, this test requires the court: (1) to determine whether the corporation is the alter ego of the defendant; (2) to determine whether justice requires disregarding the corporate form because the corporate fiction was used to perpetrate a fraud or defeat a rightful claim; and (3) to evaluate whether an equitable result will be achieved by disregarding the corporate form and holding the shareholder or other insider personally liable for the acts of the business entity.

68. *McCallum*, *supra* note 4, *citing Lowell Staats Mining Co. v. Pioneer Uravan, Inc.*, 878 F.2d 1259, 1265 (10th Cir. 1989) (applying Colorado law).

69. *McCallum*, *supra* note 4 at 78 (emphasis in original).

70. CRS § 7-108-401(5) provides that a director or officer of a corporation does not have “any fiduciary duty to any creditor of the corporation arising only from the status as a creditor.” There remains an unanswered question whether the limited trustee duty to creditors of an insolvent corporation in *Anstine*, *supra* note 12 at 498, survived the adoption of CRS § 7-108-401(5). That section was adopted specifically to address the court of appeals’ earlier decision in *Anstine*, and the Supreme Court’s decision came after the 2006 adoption of § 401(5). In footnote 9 to its *Anstine* decision, the Supreme Court noted the adoption of § 401(5) but expressed “no opinion on whether [§ 401(5)] applies where a corporation is insolvent.”

71. *Eismeier and Dindinger*, *supra* note 1 at 53, *citing Skidmore, Owings & Merrill v. Canada Life Assurance Co.*, 907 F.2d 1026, 1027 (10th Cir. 1990) (applying Colorado law). ■