COLORADO BAR ASSOCIATION
CLE IN COLORADO, INC. AND
THE BUSINESS LAW SECTION
11th Annual Business Law Institute
September 30, 2010
Denver, Colorado

Piercing the Veil and Avoiding Piercing Arguments

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Piercing the veil of a corporation has long been possible for a court using its equitable powers to hold equity owners liable for the obligations of the entity. The courts make it clear that disregarding the corporate form should be considered a "drastic remedy,"[2] and "corporate veils exist for a reason and should be pierced only reluctantly and cautiously."[3]

2009 brought two decisions from panels of the Colorado Court of Appeals, one of which applied the piercing the veil theory to limited liability companies (*"Sheffield"*[4]) and the other to corporations ("*McCallum*"[5]). 2010 brought another case ("*Colborne*"[6]) which, although it does

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1 This paper is an expanded and updated version of Lidstone, "*Piercing the Veil of an LLC or a Corporation*," 39 THE COLORADO LAWYER, no 8 at 71 (Aug. 2010).

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

3 *Boughton v. Cotter Corp.*, 65 F.3d 823, 836 (10th Cir. 1995) (applying Colorado law). *See, also, Liberty Property Trust v. Republic Properties Corporation*, 577 F.3d 335, 340 (D.C. Cir. 2009) stating: "Piercing the corporate veil 'is a step to be taken cautiously.'" [*Citation omitted.*] *See* Madden, "Piercing the Corporate Veil," in *The Practitioner's Guide to Business Organizations* (Reichert and Rozansky, eds.) ch. 32, at 32-1 (CBA Supp. 2008) which stated: "Courts have held that only extraordinary circumstances justify disregarding the corporate form to impose personal liability," *citing Leonard v. McMorris*, 63 P.3d 323, 330 (Colo. 2003).

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

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

6 *Colborne Corporation v. Weinstein*, ___ P.3d ___, 2010 WL 185416 (Colo. App. 1/21/2010); *cert. granted sub nom. Weinstein, et al. v. Colborne Corporation*, No. 10SC143, 2010 WL 3213046 (Aug. 16, 2010).

not use the term "piercing the veil," still results in the possibility that managers and members may be held personally liable for the debts of the limited liability company. 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 in Colorado 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 non-equity owners potentially liable to creditors. This article provides an overview of the opinions in these three cases and discusses certain points regarding the panels' application of the law to the facts.

This article also discusses other bases for holding members liable for the debts of the LLC, and bases for using the LLC's assets to pay the debts of the member, including provisions under the Colorado Corporations and Associations Act, using the Colorado Uniform Fraudulent Transfer Act as a means of holding owners liable, the risks of single member LLCs, and the corporate family doctrine.

Statutory Background

Both the Colorado Business Corporation Act (the "CBCA")[7] and the Colorado Limited Liability Company Act (the "LLC Act")[8] 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."[9] Directors and officers of a corporation are held to a standard of care (generally referred to as the "business judgment rule"[10] and the "duty of loyalty"[11]), although the CBCA provides that a director's liability for monetary damages can be limited.[12] Section 7-108-401(5) of the CBCA provides that directors and officers have no fiduciary duty to creditors, arising from that person's status as a creditor.[13] The CBCA goes on to provide that directors, and in some cases shareholders, can be liable for wrongful distributions.[14]

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7 C.R.S. § 7-101-101 *et seq.*, the "CBCA."

8 C.R.S. § 7-80-101, *et seq.*

9 C.R.S. § 7-106-203(2).

10 Described in C.R.S. § 7-108-401.

11 Described in C.R.S. § 7-108-501.

12 C.R.S. § 7-108-402.

13 C.R.S. § 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

- The LLC Act is even more specific in its protection of members and managers of a Colorado limited liability company. Section 7-80-705 of the LLC Act provides that: "[m]embers 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)[15] and § 7-80-606(2).[16]

- The Colorado Corporations and Associations Act (the "CCAA")[17] contains a provision[18] that can be used to hold owners[19] of a dissolved Colorado entity liable if they have received liquidating distributions of the entity. Sections 7-90-911 and -912 require that an entity in dissolution dispose of potential claims against it by notification or publication. If a dissolved entity makes liquidating distributions to its owners that do not leave sufficient assets to satisfy legitimate claims of creditors, the creditors may use § 7-90-913(1)(b) to enforce their claims against the owners who received the distributions. This requires that the entity (whether a partnership, LLC, or a corporation) be dissolved, the recipient be an owner of the dissolved entity, that the distributions and that the recipient-owner have received assets distributed in liquidation of the entity. The owner's liability to creditors is limited to the amount of assets distributed – presumably referring only to the amount of the distribution received in liquidation of the entity and not other distributions the owner may have received during the life of the entity.

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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.

[14] C.R.S. § 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. C.R.S. § 7-90-913.

[15] C.R.S. §7-80-107(1) provides that members of a limited liability company may be held liable under a piercing the veil theory for alleged improper actions of the limited liability company in accordance with the case law applicable to corporations. This section goes on to state that a failure to observe formalities relating to management "is not in itself a ground for imposing personal liability on members . . .."

[16] C.R.S. §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."

[17] C.R.S. § 7-90-101, *et seq.*

[18] C.R.S. § 7-90-913(1)(b).

[19] The term "owner" is defined in C.R.S. § 7-90-102(43) to mean (*inter alia*) shareholders of a corporation, partners of a partnership, and members of an LLC.

Prior Corporate Cases

Although Colorado had not, prior to *Sheffield*, seen a case for piercing the veil of a limited liability company, Colorado has seen a number of cases seeking to pierce the veil of a corporation to hold shareholders liable for corporate debt.[20] 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.[21] 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."[22] In *Re Phillips*,[23] the Colorado Supreme Court answered a question certified to it by the federal District Court for Colorado and set forth the "Three Prong Test" to determine whether piercing the corporate veil is appropriate. To satisfy that test, the Court held that in reviewing the question the court must:

(1) Inquire into whether the corporate entity is the alter ego of the shareholder;[24]

(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[25] 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

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[20] For a good discussion of piercing the corporate veil in Colorado and its historical development, *see* Eismeier and Dindinger, "The Alter Ego Doctrine in Colorado," 28 *The Colorado Lawyer* 53 (Mar. 1999). *See, also,* Madden, "Piercing the Corporate Veil," *in The Practitioner's Guide to Business Organizations* (Reichert and Rozansky, eds.) ch. 32, at 32-1 *et seq.* (CBA Supp. 2008).

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

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

[23] *In re Phillips*, 139 P.3d 639 at 644 (Colo. 2006). See, also, the ten factor test established by the Tenth Circuit Court of Appeals interpreting Colorado law in *Skidmore, Owings & Merrill v. Canada Life Assurance Co.* 907 F.2d 1026, 1027 (10th Cir. 1990) and the classic test for piercing the corporate veil to hold a shareholder liable for corporate obligations in *Fish v. East*, 114 F.2d 177 (10th Cir. 1940) (also interpreting Colorado law).

[24] 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 non-corporate purposes. 2009 WL 3465332 at *3.

[25] 683 P.2d 367 (Colo. App. 1984).

the court determined that equity required.[26] 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 . . . .'"[27] 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 Basham liable for those payments under a piercing the veil theory.[28] In referring to the *La Fond* decision, Hon. John W. Madden stated that "[t]he ruling may have been driven by the particular facts of the case" rather than the law.[29]

Charging Orders

Before 2009, there were no cases in Colorado addressing piercing the veil of a limited liability company, although there have been cases discussing the use of charging orders, a remedy for creditors provided in the LLC Act[30] and partnership law.[31] A charging order is singularly unsatisfying to the creditor, since the person subject to the charging order frequently controls the entity and therefore can find ways to avoid the economic obligations associated with the charging order. After disputing various actions related to a charging order in a North Carolina court, the creditor's counsel observed:[32]

> "The bad thing about having a charging order is that, at most, you get your principal and your interest – but only if the LLC works out until your judgment is paid. The charging order is worth less than selling the interest because you bear all the risk that the business will go bust before the judgment is paid. So it's worth much less than what you could get by selling it under an order. . . . If you're a member and manager of an LLC, you never have to give yourself a distribution or you don't have to do it until the judgment runs out. [The defendant] owns at least seven or eight LLCs that were formed years after the judgment with his assets, and I can't get to them. If they were shares in a corporation, we could sell them."

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[26] *Sheffield,* 211 P.3d at 721.

[27] *LaFond*, 683 P.2d at 369.

[28] *Id*. at 369-70. Clearly 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.

[29] Madden, "Piercing the Corporate Veil," *in The Practitioner's Guide to Business Organizations* (Reichert and Rozansky, eds.) ch. 32, at 32-5 (CBA 2010).

[30] C.R.S. § 7-80-703.

[31] C.R.S. § 7-60-128 (CUPL), § 7-61-123 (CULPL), § 7-62-703 (CULPA), and § 7-64-504 (CUPA, permitting a charging order against a partner's 'transferable interest.')

[32] Quoted in Leimberg's Asset Protection Planning Email Newsletter, Archive Message #24, avail. at http://leimbergservices.com (subscription only).

A charging order is issued against the member's rights to distributions from the LLC in a manner intended to avoid disrupting the entity to the detriment of the other owners and the judgment creditor.[33] As stated in a 2003 case:

> "[T]he charging order, as set forth in Section 703 of the Colorado [LLC] Act, exists to protect other members of an LLC from having involuntarily to share governance responsibilities with someone they did not choose, or from having to accept a creditor of another member as a co-manager. A charging order protects the autonomy of the original members, and their ability to manage their own enterprise."[34]

As is the case with any assets, the judgment creditor can conduct a sale of the judgment debtor's assets – including the membership interest, although sales must be completed in a manner that does not violate the operating agreement, the partnership agreement, or other agreement restricting transferability, and the purchase of the foreclosed membership interest will generally only have the limited rights of an assignee or transferee of the membership interest.[35] The statute provides that the judgment debtor may redeem the membership interest at any time prior to foreclosure.[36]

The Law In Other Jurisdictions

The *Sheffield* case is the first case in Colorado addressing piercing the veil of a limited liability company, and one would think that the Court of Appeals would have looked to guidance from other jurisdictions in reaching its decision. Several other jurisdictions have addressed the question of piercing the veil of a limited liability company, in each case finding that the target of piercing the veil must also be a member. The federal District Court for the District of Oregon stated that it would allow the piercing of the limited liability veil of an LLC where:

- the defendant member controlled the debtor;
- the defendant member engaged in improper conduct; and

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[33] *See Union Colony Bank of Greeley v. United Bank of Greeley*, 832 P.2d 1112, 1114-15 (Colo. 1992); J. Gordon Gose, "The Charging Order Under the Uniform Partnership Act," 28 WASH. L. REV. 1 (1953).

[34] *In re Ashley Albright*, 291 B.R. 538, 541 (Bankr. D. Colo. 2003).

[35] C.R.S. § 7-80-703, second sentence. Unless the operating agreement provides to the contrary, "the assignee or transferee shall only be entitled to receive the share of profits or other compensation by way of income and the return of contributions to which that member would otherwise be entitled and shall have no right to participate in the management of the business and activities of the limited liability company or to become a member." C.R.S. § 7-80-702(1), second sentence.

[36] C.R.S. § 7-80-703, third sentence.

- 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.[37]

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."[38] The trial court could not determine the third factor on motions and left it for determination at trial.[39]

In another case, the Delaware Chancery Court indicated that the circumstances necessary to pierce the veil of an LLC must be pervasive – not just stemming from a single transaction.[40]

In a detailed Second Circuit Court of Appeals decision discussing the piercing of a veil of a Delaware LLC,[41] the plaintiffs sought to hold the sole member of a Delaware LLC liable for the 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 Court of Appeals 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:

(1) *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*

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

[38] *Id*. at *5.

[39] *Id*. at *6.

[40] In *EBG Holdings LLC v. Vredezicht'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.

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

contracting with each other it would be tantamount to declaring that they are indeed one in the same.'"[42]

(2) *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.[43]

(3) *Treating the LLC's funds as if it were the member's* – the member put money into the LLC as needed and took money out as the member needed it.

(4) *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.

(5) *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.

(6) *Personal use of LLC funds* – the court reviewed evidence relating to financial transactions involving the LLC, including:

a. The LLC made transfers to the member or third parties on his behalf in connection with living expenses.

b. The individual in charge of the LLC's financial records testified that the member made the decision to treat moneys 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.

c. 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 find 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 the LLC and its member operated as a single entity and in the proof relating to unfairness.

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[42] *Id*. at 178. The Colorado LLC Act specifically states that a failure to observe formalities relating to management "is not in itself a ground for imposing personal liability on members." C.R.S. § 7-80-107(1).

[43] 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 (Thompson/West, 2d ed. Supp. 2006).

The Court pointed out that the member's withdrawals of money 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 mask 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 and evidence that the member withdrew more money from the LLC than he put in. 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, however. 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.[44] A number of lower courts nationally have addressed the question of piercing the veil of an LLC and have generally concluded that "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.'"[45]

Sheffield v. Trowbridge

The Facts[46]

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"). 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 member of Colfax. Both Colfax and Villa had obligations under a

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

45 *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, protecting a member of an LLC from personal liability, "'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 (Con. App. 2005), certification granted in part, 883 A.2d 1245 (Conn. 2005); *Lily Transp. Corp. v. Royal Institutional Services, Inc.*, 832 N.E.2d 666 (Mass. App. Ct. 2005), review denied, 836 N.E.2d 1096 (Mass. 2005); and *Pinebrook Properties, Ltd. v. Brookhaven Lake Property Owners Ass'n,* 77 S.W.3d 487 (Tex. App. 2002).

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

1998 development agreement with the City and County of Broomfield.[47] It is clear that the two LLCs failed to meet their obligations to Broomfield and Broomfield declared a breach.[48] 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 closing on June 30, 2004. As manager of Colfax, Trowbridge signed the Sheffield-Colfax agreement and then 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 told them 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.[49] 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 as to 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."[50]

Trowbridge owned another entity, Krystal Custom Homes, LLC ("Krystal") which owned various water and sewer taps. As a 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.[51] The trial court noted that Krystal (which was in foreclosure for unrelated debts at the

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47 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 at 2.

48 *Sheffield*, 211 P.3d at 717.

49 *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 Broomfield would withhold building permits if Colfax and Villa failed to comply with the Development Agreement. *Id*. at 717-18.

50 Amended Order at 7 and 23.

51 *Id*. at 6.

time) obtained no known benefit from the sale of its water taps since Sheffield made payment for the taps to the operating account of Trowbridge Agency for the benefit of Villa, not to Krystal.[52]

Another complicating factor was that in November 2003 Trowbridge and Dr. Ron Yaros, 50 percent member of Colfax, 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 [Dr. 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."[53] On July 2, 2004 (two days after the Colfax-Sheffield closing),[54] the Trowbridge Agency, on behalf of Colfax, paid Dr. Yaros $500,000 as a loan repayment and $45,000 as an expense reimbursement.[55]

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."[56] All payments for Colfax and Villa, including the payments to Dr. Yaros, were made out of the Trowbridge Agency Sales Escrow Account. After noting this, the trial court continued saying "[w]hen 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."[57] 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."[58] Finally, the trial court also concluded that "the level of control that Defendant Trowbridge maintained over the multiple

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[52] *Id*. at 7.

[53] *Id*. at 10.

[54] *Id*. at 22. The District Court makes a number of apparent errors in the dates in its order. Although it states "two days after closing," it refers to 2007, not 2004. On page 5, it refers to May 3, 2007 as preceding May 14, 2004.

[55] The District Court noted the expense reimbursement was unusual where the testimony was that Dr. 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 Dr. Yaros' contribution and distributions made to him." *Id*. at 22.

[56] *Id*. at 22. This shows the danger of a specific operating agreement requirement for meetings and minutes – matters that are not required by the LLC Act.

[57] *Id*. at 23.

[58] *Id*. at 24.

limited liability companies' assets, using them interchangeably to meet his needs, is highly unusual."[59]

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."[60] 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 neither of the members of Colfax were parties to the case.[61]

The Court of Appeals' Decision

In its decision, the *Sheffield* panel reversed the trial court on the question of Trowbridge's personal liability on grounds that create confusion for business practitioners and raise questions on the adequacy of the liability protection of the LLC form as compared to other limited liability entities. Notwithstanding the plain language of C.R.S. § 7-80-705,[62] the *Sheffield* panel referred to C.R.S. § 7-80-107(1) and concluded that "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."[63] The *Sheffield* panel also cited *LaFond v. Basham*[64] 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."[65] The *Sheffield* panel went on to state that "[w]hether 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."[66]

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[59] *Id*. at 7.

[60] *Id*. at 25.

[61] *Id*. at 26-27.

[62] "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."

[63] *Sheffield*, 211 P.3d at 719; *see also* 211 P.3d. 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."

[64] *LaFond v. Basham,* 683 P.2d 367 (Colo. App. 1984). Discussed above beginning at note 22 *et seq*.

[65] *Sheffield,* 211 P.3d at 721.

[66] *Sheffield, 211 P.3d* at 721. The Sheffield Panel went on to refer to the District Court's finding at 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*, 211 P.3d at 722. To clarify this issue, one of the *Sheffield* panel's

To support its conclusion, the *Sheffield* panel also cited *Alexander v. Anstine*.[67] 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.[68]

The Court noted that the Colorado legislature adopted C.R.S. § 7-108-401(5) directly in response to the Court of Appeals' earlier decision in *Anstine*, but expressed "no opinion on whether [C.R.S. § 7-108-401(5)] applies where a corporation is insolvent."[69]

To the extent this "limited duty" analysis survived the adoption of C.R.S. § 7-108-401(5) (a point that has not yet been determined), *Anstine* is a more appropriate analysis to hold a non-member manager of an LLC liable where it can be shown that he favored personal interests over those of a creditor, rather than the confused application of *LaFond* where the defendant claimed to own the corporation. As discussed in the next section, there is significant question whether the *Anstine* analysis has survived the legislative action enacting § 7-108-401(5) notwithstanding the assumptions made by the *Sheffield*, *Colborne*, and *McCallum* panels that there is no issue.

Colborne Corporation v. Weinstein

In January 2010, a different panel of the Colorado Court of Appeals decided *Colborne Corporation v. Weinstein*.[70] In *Colborne*, the trial court had dismissed a complaint for failure to state a claim against members of a limited liability company 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

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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."

[67] 152 P.3d 497, 502 (Colo. 2007), cited at *Sheffield*, 211 P.3d at 723.

[68] *Anstine*, 152 P.3d at 502. Citations omitted.

[69] *Anstine* at 502, n. 9. *See* discussion of C.R.S. §7-108-401(5) in the text at n. 13, above.

[70] *Colborne Corporation v. Weinstein*, ___ P.3d ___, 2010 WL 185416 (Colo. App. 1/21/2010); *cert. granted sub nom. Weinstein, et al. v. Colborne Corporation*, No. 10SC143, 2010 WL 3213046 (Aug. 16, 2010).

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 which rendered Boulder insolvent, in violation of C.R.S. § 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 C.R.S. § 7-80-606 and the common law duty approved by *Anstine* did not apply to limited liability companies.

C.R.S. § 7-80-606(1) provides that a limited liability company shall not make distributions to its members if the distribution would render the limited liability company insolvent. C.R.S. § 7-80-606(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 (the "CCC," repealed as of July 1, 1994) and the CBCA to determine that, notwithstanding the statutory language, the statutory language of the corporation laws providing for directors' liability "to the corporation" has been interpreted to give creditors standing to sue in the corporation's stead and this analysis should extend to limited liability companies under §7-80-606.

The principal case cited by the *Colborne* panel for this proposition was *Ficor, Inc. v. McHugh*,[71] decided under § 7-5-114(3) of the now-repealed 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 being 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].[72]

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

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[71] 639 P.2d 385, 393 (Colo. 1982). Both the *Sheffield* and *McCallum* panels also relied on *Ficor, Inc. v. McHugh*.

[72] The *Colborne* 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 §7-108-403.

sue an LLC member who knowingly receives an unlawful distribution pursuant to section 7-80-606" even though the statute speaks only to the right of the limited liability company 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 contained no analysis of the Supreme Court's footnote 9 in *Anstine*[73] or whether the theory survived the adoption of §7-108-401(5).

The *Colborne* panel takes great care to discuss statutory history of the CCC and the CBCA and the 1990 adoption of the LLC Act. The *Colborne* panel does not consider the fact that the legislature adopted § 7-108-401(5) expressly to address the Court of Appeals decision in *Anstine*. The *Colborne* panel also failed to note *Anstine*'s footnote 9 which left the question of the applicability of the statute in insolvency open for further analysis.

In August 2010, the Colorado Supreme Court granted *certiorari* in this case[74] for consideration of the following issues:

> Whether the creditors of a limited liability company ("LLC") have standing to sue individual members of the LLC who have allegedly received an unlawful distribution under section 7-80-606, C.R.S. of the LLC Act. (the *Ficor* issue); and
>
> Whether the court of appeals erred in extending the limited common law fiduciary duty which directors of insolvent corporations owe to an insolvent corporation's creditors to managers of LLCs (the *Anstine* pre-§ 7-108-401(5) issue).

While the Supreme Court generally addresses matters presented to it narrowly, this appeal will give it the opportunity to reassess its 1982 decision in *Ficor, Inc. v. McHugh.*[75] In *Ficor*, the Court reviewed the statutory language that made it clear that only the corporation has a right to bring an action against a director for approving a wrongful distribution, but determined that, since the provision appeared to be for the benefit of creditors, creditors could do so also. This will also give the Supreme Court the opportunity to reassess its footnote 9 to the *Anstine* opinion and the effect of the subsequent statutory amendment in § 7-108-401(5). Of course, *Colborne* deals only with these issues in the context of a limited liability company, and both *Ficor* and *Anstine* were cases involving corporations. The Supreme Court may, therefore, choose not to decide these issues more broadly than necessary.

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

[74] *Weinstein, et al. v. Colborne Corporation*, 10SC143, 2010 WL 3213046 (Colo. 2010).

[75] 639 P.2d 385, 393 (Colo. 1982). Both the *Sheffield* and *McCallum* panels also relied on *Ficor, Inc. v. McHugh*.

McCallum Family LLC v. Winger[76]

The facts of the *McCallum* case are similar to *LaFond* and (unlike *Sheffield* and *Colborne*) involve the piercing of a corporate veil. Although Marc Winger ("Marc") was neither a shareholder, officer nor director of the corporation (Manitoba Investment Advisors, Inc., "Manitoba"), like Basham, Marc was a corporate insider who "essentially functioned as an owner," and "managed the whole affair." McCallum Family LLC had obtained a judgment against Manitoba for $76,224. The two shareholders of Manitoba were Marc's 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.[77]

The *McCallum* trial court held that piercing the veil against one who was not an equity owner was inappropriate. By finding that Marc was the equitable owner and alter ego of Manitoba, the *McCallum* panel justified holding Marc liable under a piercing the corporate veil theory.[78]

In considering the veil piercing claim, the *McCallum* panel applied the "Three Prong Test" established by the Colorado Supreme Court in *In re Phillips* which is discussed above.[79] 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

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[76] 221 P.3d 69 (Colo. App. 2009).

[77] *McCallum*, 221 P.3d at 77. Although not previously used in Colorado, the doctrine of equitable ownership has been used elsewhere where "an individual who exercises sufficient control over the corporation may be deemed an equitable owner, notwithstanding the fact that the individual is not a shareholder of the corporation." *In re Tyson*, 2010 WL 2925112, *18 (S.D.N.Y. 2010). In applying this test, courts have concluded that "it must be shown that the defendant exercised considerable authority over the corporation to the point of completely disregarding the corporate form and acting as though its assets were his alone to manage and distribute." This was clearly the case in *McCallum* and *Sheffield*, even though the doctrine was not referenced by the *Sheffield* court.

[78] *McCallum* 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."

[79] Discussed in the narrative at notes 23-24. As discussed above, this test requires the court: (i) to determine whether the corporation is the *alter ego* of the defendant, (ii) 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 (iii) 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.

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 first 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."[80] 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."[81] Based on Winger's actions which "removed all available corporate funds" from Manitoba, the *McCallum* panel determined that the second prong was met without requiring an additional showing that Winger's actions were specifically directed at defeating the creditor's rights. Again, the panel had no trouble reaching this conclusion based on the facts as determined by the trial court.

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 its consideration of this prong. In the remand, 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 did mention C.R.S. § 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.[82] 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 the payment of that dividend did not disadvantage creditors to her benefit.

In reaching this conclusion, the *McCallum* 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

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[80] Citing *Lowell Staats Mining Co. v. Pioneer Uravan, Inc.,* 878 F.2d 1259, 1265 (10th Cir.1989) (applying Colorado law).

[81] *McCallum*, 221 P.3d at 78. Emphasis in original.

[82] §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 *Alexander v. Anstine*, 152 P.3d 497, 498 (Colo. 2007) survived the adoption of § 7-108-401(5). That section was adopted specifically to address the Court of Appeals' earlier decision in *Anstine*, and the Supreme Court decision came after the 2006 adoption of § 7-108-401(5). In footnote 9 to its *Anstine* decision, the Supreme Court noted the adoption of § 7-108-401(5) but expressed "no opinion on whether [§ 7-108-401(5)] applies where a corporation is insolvent."

time Manitoba paid Marc distributions after the September 2004 determination of insolvency to the detriment of Manitoba's creditors. 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)). Even if Karen had not participated in the decisions to approve the distributions to Marc, the panel could have found her responsible as a result of her total dereliction of duties as an officer and director. While those duties are normally owed to shareholders, arguably the panel could have interpreted them to be part of the limited trustee duties under *Anstine*. In deciding the case against Karen, however, the panel did nothing except conclude that Karen could escape liability because the distributions she received were before Manitoba's date of insolvency. The panel did not focus at all on Karen's role as an officer or director which is the intended focus of C.R.S. § 7-108-401(5). Nor did the Court address whether Karen could be liable under C.R.S. § 7-108-403, which imposes liability on directors who approve distributions from an insolvent corporation.

Avoid the Piercing Argument - CUFTA and the LLC Act

CB Richard Ellis, Inc. v. CLGP, LLC, et al.[83] was decided by the Court of Appeals on July 22, 2010. It provides an interesting twist to the traditional analysis of piercing the veil of a limited liability company to hold members liable for the LLC's debts. Unlike the "piercing the veil" theory applied by the Court of Appeals in *Sheffield* and *Colborne*, in *CBRE* the creditor makes the argument that the distribution paid to the members of the LLC were conveyances that violated the Colorado Uniform Fraudulent Transfer Act[84] ("CUFTA"). The Appellant creditor did not address whether the distributions were improper under the Colorado Limited Liability Company Act (the "LLC Act"),[85] and the Court of Appeals' decision did not address the question.[86]

CLGP owned property near Park Meadows Mall. It entered into a listing contract with CBRE in March 2004 which (after several extensions) expired in September 2006. The listing agreement contained a standard "holdover" provision so that if a sale was made within 180 days after the expiration of the listing period the full commission was payable to CBRE if the buyer had been submitted in writing to CLGP and the buyer was one with whom CBRE had "negotiated" (the "Holdover Conditions"). Within the 180 day period, a sale was completed that would have resulted in a $177,000 commission to CBRE had it met the Holdover Conditions.

Predictably, CLGP and its two members did not believe that CBRE had met the Holdover Conditions and directed the title company not to pay the disputed commission. At the closing, the title company wired the funds directly to the two members who then wrote (each) $100,000

83 ___ P.3d ____, 2010 WL 2853756 (Colo. App., Jul. 22, 2010).

84 CRS §§ 38-8-101 *et seq.* ("CUFTA").

85 CRS § 7-80-606,

86 The defendants argued that the LLC Act was the only basis for liability of wrongfully-paid distributions; by addressing only the CUFTA issues, the Court of Appeals seems to have determined otherwise, at least for the issues of the case presented.

promissory notes to CLGP to provide for the estimated amount of potential contingent liability to CBRE. CBRE took the matter through mediation and arbitration, and won an arbitral award for the full amount of the commission, $168,000 in attorneys' fees, $23,000 in costs, and interest, less certain awards to CLGP for a total award to CBRE of $374,000. At that time, after CLGP paid its and its members' legal fees, there remained for CBRE only about $47,000 of the $200,000 which the members had paid back to CLGP under the promissory notes.

Not happy with that conclusion, CBRE garnished both members for the amount of their distributions. The trial court denied the plaintiff's verified motions for traverse of the garnishment and any relief to CBRE. The principal claim at the trial court level was that the payments to the members violated CUFTA. Neither Appellant's brief nor its reply brief addressed whether the distributions violated CRS § 7-80-606(1), which prohibits an LLC from making a distribution to the extent that at the time of the distribution and after giving effect to the distribution, liabilities exceed the fair value of the remaining assets.

The LLC Act liability provisions differ from CUFTA in a number of material respects. A significant difference between the liability provisions of CUFTA and the LLC Act is the statute of limitations. Under CRS § 7-80-606(2), a member is only liable for a distribution made in violation of § 606(1) for three years after the distribution, and then only if the member knew that the distribution violated § 606(1). CRS § 38-8-110 provides for a four year statute of limitations for liability under CRS § 38-8-105 (discussed below) and one year under CRS § 38-8-106 (also discussed below).

More importantly, however, CRS § 7-80-606(2) provides that a member who knowingly receives a wrongful distribution is liable to the LLC for the amount of the distribution. Under CUFTA, the transferee is liable to the creditor. While there is some case law (beginning with *Ficor, Inc. v. McHugh*[87] and including both *Sheffield* and *Colborne*) that the intention of § 7-80-606(2) is to protect creditors so that the members should be liable to creditors directly, that is not the statutory wording. CUFTA, on the other hand, clearly gives a creditor a cause of action in three circumstances:

- CRS § 38-8-106(1) and (2) provides that transfers are fraudulent as to creditors existing at the time of transfer if the debtor was insolvent at the time of the transfer or became insolvent as a result thereof. CUFTA[88] defines insolvency similarly to the LLC Act, stating that a debtor is insolvent if the sum of the debtor's debts is greater than all of the debtor's assets at a fair valuation. Unlike the LLC Act, CUFTA has a second definition for a rebuttable presumption of insolvency: when a debtor is generally not paying debts as they become due.[89]

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[87] 639 P.2d 385, 393 (Colo. 1982).

[88] CRS § 38-8-103(1).

[89] CRS § 38-8-103(2).

- CRS § 38-8-105(1)(a) provides that transfers are fraudulent as to creditors existing at the time of the transfer and future creditors where the debtor makes a transfer with actual intent to hinder, delay or defraud any creditor. CRS § 38-8-105(2) sets forth eleven factors for a court to consider in determining intent, including insolvency as a factor to be considered.

- CRS § 38-8-105(1)(b) provides that transfers are fraudulent as to creditors existing at the time of the transfer and future creditors where the debtor makes a transfer without receiving "reasonably equivalent value in exchange for the transfer" **and**

  (I) Was engaged or was about to engage in a business or transaction for which the debtor's remaining assets were unreasonably small; or

  (II) The debtor intended to incur (or believed or reasonably should have believed that the debtor would incur) debts beyond the debtor's ability to pay as they became due.

CBRE did not argue that the members were liable under CRS § 38-8-105(1)(a) (which the Court of Appeals identifies as "actual fraud" requiring an element of intent), but relied on its arguments that the distributions constituted "constructive fraud" under CRS § 38-8-106(1) and (2) (requiring insolvency) and CRS § 38-8-105(1)(b) (requiring a transfer without reasonably equivalent value). There is no need to prove an intent to delay, hinder or defraud creditors if alleging constructive fraud, although it is an element of actual fraud under CRS § 38-8-105(1)(a).

Addressing the arguments under CRS § 38-8-105(1)(b), the trial court originally found that the distribution of profits to members of an LLC was "always for reasonably equivalent value" but then, after reviewing cases cited by CBRE conceded that he might have been "wrong in concluding that the distributions here were for reasonably equivalent value." The trial court then listed factors that CBRE needed to prove "in order to prevail under [section] 38-8-105(1)(b)." The Appellant argued that the court's finding "was legal error." The Court of Appeals did not determine whether the trial court's original finding was in error, but ruled that CBRE did not prove the other elements the trial court established. Since the burden was on CBRE to prove lack of reasonably equivalent value, the Court of Appeals upheld the trial court's ruling on that issue.

The trial court then considered whether, in light of the potential $177,000 obligation for the commission allegedly due to CBRE at the time of the distribution, net assets of $200,000 resulted in insolvency or could insolvency have been reasonably anticipated? Judge Hoffman did not find CBRE's evidence of insolvency to be credible. As summarized by the Appellees in their answer brief to the Court of Appeals, the trial court stated:

> "CBRE failed to prove CLGP was insolvent. It failed to prove CLGP intended to reserve an insufficient amount, or reasonably should have believed the amount retained was insufficient to pay its debts. CBRE also failed to prove that the $200,000 was an unreasonably small amount in relation to CBRE's disputed claim."

Without a factual finding of insolvency, CBRE's claims under CRS § 38-8-105 and § 106 were not viable. In its opinion, the Court of Appeals reviewed various bases for determining insolvency:

- The "unreasonably small assets test" of CRS § 38-8-105(1)(b)(I) "denotes a financial condition short of insolvency." A company can be solvent, even though (at the time) it is holding an unreasonably small amount of assets necessary to carry on the company's business when compared to historical level of assets, cash flow, and working capital.

- The "debts beyond the ability to pay" test of CRS § 38-8-105(1)(b)(II) exists when the debtor "[i]ntended to incur, or believed or reasonably should have believed that he would incur, debts beyond his ability to pay" after making the questionable transfer."

- For the purposes of CRS § 38-8-106(1), "Insolvency" is defined in CRS § 38-8-103(1) as being where "the sum of the debtor's debts is greater than all of the debtor's assets at a fair valuation" after making the questionable transfer, mirroring the balance-sheet test for insolvency under 15 U.S.C § 548 of the Bankruptcy Code.

In considering CBRE's appeal, the Court of Appeals noted that at the time of the distribution, CBRE's claim was contingent, and the fair value of a contingent claim (for the purposes of determining solvency) can be discounted from the actual claim amount. The Court of Appeals also noted that a "conveyance cannot become fraudulent at some point after its occurrence. It must either be fraudulent or non-fraudulent when executed." Applying these principals, the Court of Appeals noted that the $200,000 reserved was reasonable to pay the $177,000 commission, even including interest at 12 percent per annum through the date the arbitration began. The Court of Appeals found that there was evidence to support the garnishee's belief that CBRE would likely settle for one-half of the disputed amount due, and further evidence that the garnishees could not have anticipated that CBRE would take the case to the lengths and at the cost that resulted. The Court of Appeals therefore affirmed the trial court's determination that CLGP was not insolvent at the time of, or rendered insolvent as a result of, the distribution to its members.

An interesting question from the business lawyer's perspective is whether CUFTA can serve to circumvent the express provisions of CRS § 7-80-705 of the LLC Act that "[m]embers 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." In its argument that the LLC Act is not the exclusive means by which a creditor may hold a member of an LLC liable for unlawful distributions, CBRE cited[90] both a New York bankruptcy case[91] and the last sentence of CRS § 7-80-606(2) which provides:

> "Subject to subsection (3) of this section [which provides for the three year statute of limitations], this subsection (2) shall not affect any obligation or liability of a member

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[90] Reply brief at page 8.

[91] *In re Die Fliedermaus LLC*, 323 B.R. 101 (Bankr. SDNY 2005).

under an agreement **or other applicable law** for the amount of a distribution." (emphasis added)

CBRE urged the Court of Appeals to read the last sentence of CRS § 7-80-606(2) to preserve claims under CUFTA against members of an LLC who receive distributions regardless of whether the distribution violated § 7-80-606(1). The Appellees predictably took the opposite view, stating[92] that § 7-80-606 describes the only circumstances under which a distribution can be clawed back from a member. The Appellees argued that any more expansive reading means that any distribution made by an LLC leaves a member with the risk that the distribution may later be determined to be a fraudulent transfer and recoverable, notwithstanding the limitations of § 7-80-606. The Court of Appeals did not address these arguments, but by not doing so it implicitly held that, for the purposes of this case, CUFTA provided a potential remedy. Given the "or other applicable law" language of CRS § 7-80-606(2), this is probably the correct result.

Avoid the Piercing Argument – Colorado Corporations and Associations Act

The Colorado Corporations and Associations Act (the "CCAA")[93] contains a provision[94] that can be used to hold owners[95] of a dissolved domestic entity liable if they have received liquidating distributions from the entity. Sections 7-90-911 and -912 require that an entity in dissolution dispose of potential claims against it by notification or publication. If a dissolved entity makes liquidating distributions to its owners that do not leave sufficient assets to satisfy legitimate claims of creditors, the creditors may use § 7-90-913(1)(b) to enforce their claims against the owners who received the distributions. C.R.S. § 7-90-913(1)(b) provides that a claim may be enforced against an owner of a dissolved domestic entity if the entity has distributed assets to that owner in liquidation of the entity.

This section contains a proviso, however, stating that the owner's total liability for all claims "shall not exceed the total value of assets distributed to the owner, as such value is determined at the time of distribution." This section also allows the owner found liable to seek contribution from the other owners.

This requires that the entity (whether a partnership, LLC, or a corporation) be dissolved, the recipient be an owner of the dissolved entity, and that the recipient-owner have received assets distributed in liquidation of the entity. The owner's liability is limited to the amount of assets distributed – presumably referring only to the amount of the distribution received in liquidation of the entity and not other distributions the owner may have received during the life of the entity. Nevertheless, this liability under the CCAA is in addition to the statutory liability for wrongful distributions as set forth in:

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[92] Answer brief at page 16.

[93] C.R.S. § 7-90-101, *et seq.*

[94] C.R.S. § 7-90-913(1)(b).

[95] The term "owner" is defined in C.R.S. § 7-90-102(43) to mean (*inter alia*) shareholders of a corporation, partners of a partnership, and members of an LLC.

- § 7-60-134 providing the right of a CUPL partner to recover from other partners of the partnership to the extent a partner fails to contribute the amounts required by that partner's share;
- § 7-60-140 (rules for distribution under CUPL) and the resulting liability for wrongful distributions from LLPs in § 7-60-146;
- § 7-62-608 discussing liability of partners under CULPA for distributions made in violation of the partnership agreement or CULPA;
- § 7-63-116(3) discussing the potential liability of members of a limited partnership association for distributions, the result of which creditors cannot be paid;
- § 7-64-807 providing the right of a CUPA partner to recover from other partners of the partnership to the extent a partner fails to contribute the amounts required by that partner's share;
- § 7-64-1004 discussing liability of partners under CUPA for distributions made in violation of the partnership agreement or CUPA;
- § 7-80-606(2) discussing liability of members under the LLC Act for distributions made in violation of the operating agreement or the LLC Act; and
- § 7-108-403 discussing the liability of directors and shareholders for a wrongful distribution by a corporation.

Single Member LLCs Are Treated Differently.

Foreclosure and Substitution of Member. If a charging order is intended to protect the rights of the other (non-debtor) members and partners as described in *Union Colony Bank of Greeley*[96], the rationale for a charging order does not apply to a single member LLC (or to a dual member LLC where both members are debtors under the same obligation). In that case, a creditor perhaps should have the right to pierce through the protective veil of the LLC and foreclose against its assets since there are no other members to be disadvantaged. Alternatively, by acquiring the only membership interests in foreclosure (even as a transferee), the secured party should be entitled to take over the management of the entity.[97] Where the member of a single-member LLC files a petition in bankruptcy, it is treated as though the member made an assignment of her assets to the bankruptcy trustee – and that would include the members interest in the single member LLC.[98] Similarly where a creditor acquires an interest through foreclosure of a judgment lien or a charging order, the creditor would be considered an "assignee." There

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[96] *See Union Colony Bank of Greeley v. United Bank of Greeley*, 832 P.2d 1112, 1114-15 (Colo. 1992); Nash and Bedingfield, *Charging Partnership and LLC Interests to Satisfy Creditors*, 23 THE COLO. L. 2743 (Dec. 1994); J. Gordon Gose, "The Charging Order Under the Uniform Partnership Act," 28 WASH. L. REV. 1 (1953). *See, also,* discussion of charging orders in the text at notes 30-36, above.

[97] Under Colorado law, where the LLC has no members, the non-member assignees may, by the unanimous consent of the assignees, "be admitted as a member." C.R.S. § 7-80-701(2).

[98] 11 U.S.C. § 541 of the Bankruptcy Code provides in relevant part that upon the commencement of a case in bankruptcy, an estate is created. That estate includes the bankruptcy debtor's legal and equitable interests in real and personal property as of the commencement of the case. As provided in C.R.S. § 7-80-702(1), a membership interest in an LLC is personal property.

would be no other members of the LLC since "a member ceases to be a member upon assignment or transfer of all of the member's membership interest."[99] The creditor could then appoint itself as a member.[100] The member could then appoint itself as manager (in a manager-managed LLC), amend the operating agreement, and take other actions as a member to obtain value from the membership interest. While the operating agreement may impose certain limitations, ultimately the operating agreement is the agreement of all of the members,[101] and as the sole member the secured party will be able to make appropriate amendments.

As a result of the Colorado LLC Act discussed above, the cases dealing with the question of single member LLCs and their relationship with creditors and bankruptcy trustees from Arizona,[102] Colorado,[103] Florida,[104] Maryland,[105] and other jurisdictions become less relevant in Colorado. Furthermore, the statute makes a single-member LLC a much less attractive device for asset protection by that single member, and commentators have expressed doubt that a single member LLC (or a dual member LLC where both members are subject to the same obligation and have filed bankruptcy[106]) will provide any meaningful asset protection benefit for the member. Colorado courts have held that an individual should be responsible for his or her own torts and liabilities.[107]

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[99] C.R.S. § 7-80-702(2).

[100] C.R.S. § 7-80-701(2).

[101] C.R.S. § 7-80-102(11)(a).

[102] *Movitz v. Fiesta Investments, LLC (In re Ehmann)*, 319 B.R. 200 (Bankr. D.Ariz. 2005), (decided on a motion to dismiss) holding that when a member of an LLC files for bankruptcy protection, the debtor's membership interest becomes an asset of the bankruptcy estate, entitling the estate to the rights of an assignee, including distributions. This decision was so negative for the LLC that it paid $85,000 to settle all creditor claims and all administrative costs in full. This payment was conditioned on the court's withdrawal of its earlier opinion to "eliminat[e] any precedential effect" of the earlier opinion. *In re Ehmann*, 337 B.R. 228 (Bankr. D.Ariz. 2006) *vacating* 319 B.R. 200 (Bankr. D.Ariz. 2005).

[103] *In re Ashley Albright*, 291 B.R. 538 (Bankr. D. Colo. 2003); *In re Scott A. Lowe and Allyson R. Lowe*, 07-10904 MER (Bankr. D.Colo.), transcript of oral ruling, Oct. 17, 2007.

[104] *Olmstead v. Federal Trade Commission*, ___ So.3d ___, 2010 WL 2518106 at *1 (Fla. 2010) in which the Florida Supreme Court (answering a question from the Eleventh Circuit) held that Florida's LLC Act's "statutory charging order does not preclude" a creditor attaching and foreclosing on a debtor's interest in a single member LLC.

[105] *In re Modanlo*, Civ. Act 2006-1168 (Oct. 11, 2006) (US D.Ct. Md.), holding held that since the bankruptcy trustee was the personal representative of the last remaining member, the bankruptcy trustee could (under 6 Del. C. § 18-801(a)) admit himself or nominee as a member and continue the LLC over the objections of the bankrupt debtor.

[106] *See* Allen Sparkman, *Family Business Entities: Preserving Wealth and Minimizing Taxes*, 32 THE COLO. LAW. 11 (Nov. 2003) at n. 133.

[107] *Valley Dev. Co. v. Weeks*, 364 P.2d 730, 734 (Colo. 1961).

The question whether an LLC is a single member LLC seems straightforward, but it is not. A person can establish an LLC with a number of non-economic members as permitted by Colorado law,[108] and may grant economic interests to family members for no or little consideration, in an estate planning or even a business context. These may, or may not, be effective to avoid the single-member issues. In *In re Ashley Albright*,[109] the bankruptcy court substituted the bankruptcy trustee for the single member in a reasoned decision before the statutory amendments. Footnote 9 to the *Albright* decision makes it clear that the additional members have to be members with a true interest in the LLC. "To the extent a debtor intends to hinder, delay or defraud creditors through a multi-member LLC with 'peppercorn' co-members, bankruptcy avoidance provisions and fraudulent transfer law would provide creditors or a bankruptcy trustee with recourse."[110]

There is likely to be significant discussion in forthcoming cases where an LLC, seeking to avoid the risks of associated with a single member LLC, brings in other members as described above. The court's determination whether the members are "peppercorn members" should turn on the significance of the rights they have, the terms of the operating agreement, and perhaps other law, such as the Colorado Uniform Fraudulent Conveyances Act.[111]

Single Member LLCs – Single Purpose Entities and the Corporate Family Doctrine. Although also not a case involving piercing the veil of a limited liability company or a corporation and not involving Colorado law, the *In Re General Growth Properties, Inc.*[112] bankruptcy case from the Southern District of New York is an important case to consider for structuring limited liability companies as single purpose entities. This case originally raised the bankruptcy spectre of "substantive consolidation" which would have resulted in disregard of the separateness of the subsidiary LLCs, but the court finally reached its decision based on the "corporate family" doctrine, in which the bankruptcy court ignored the separateness of the SPEs from their Parent, although not utilizing either a piercing-the-veil or substantive consolidation rationale.

Even so, *General Growth* may have far-reaching consequences in structured real estate financing transactions that involve the isolation in a special purpose (or single purpose) entity (an "SPE") of income producing assets to protect the creditor with a security interest in those assets from the risk of bankruptcy. The *General Growth* court protected secured creditors of the SPEs by ensuring "adequate protection," but where the secured creditors of the SPEs were over-collateralized (that is, collateral value was greater than the collateralized debt), the court permitted the SPEs to use the over-collateralization to finance the parent's bankruptcy and

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[108] C.R.S. § 7-80-501.

[109] 291 B.R. 538 (Bankr. D. Colo. 2003).

[110] *Citing* 11 U.S.C. §§ 544(b)(1) and 548(a).

[111] CRS §§ 38-8-101 *et seq.* ("CUFTA").

[112] *In re General Growth Properties, Inc.*, 409 B.R. 43, No 09-11977 (ALG) (Bankr. S.D.N.Y. 2009).

operations – rather than retaining those assets in the SPE for the benefit of the secured creditor as was contemplated by the agreements with the secured creditors.

Many real estate transactions occur through a structured financing transaction where the principal (the "Parent") transfers income producing assets to be financed (the "Project") into an SPE (usually organized as a limited liability company) which a lender will then finance. Two legal concepts are crucial to this transaction. The first is that the transfer of the assets that constitute the Project to the SPE must be recognized in any subsequent bankruptcy of the Parent or the SPE, avoiding preferential transfer and fraudulent conveyance issues under the Bankruptcy Code.[113] This requires that the transfer be accomplished pursuant to a "true sale" in which the ownership of the Project has been transferred to the SPE in a manner that the Parent does not retain any residual interest that will affect the ability of the SPE to realize on the assets, especially in the context of the bankruptcy of the Parent. The second concept is non-consolidation - that is, that the legal separateness of the SPE will be respected in the event of a bankruptcy by the Parent or other affiliated person so that the bankruptcy court will not draw the assets of the SPE back to the Parent through the bankruptcy court's power of substantive consolidation.

Another common feature of SPEs is bankruptcy remoteness. To achieve bankruptcy remoteness, the risk of bankruptcy filing by or against the SPE is made unlikely by contractually restricting the SPE's ability to incur indebtedness unrelated to the structured financing and limiting the ability of the Parent and other affiliates of the SPE to cause the SPE to file for bankruptcy protection voluntarily. This usually is accomplished by requiring the consent for any bankruptcy filing by an "independent manager" or other person charged with protecting the creditor's interests. While it has long been thought that an entity does not have to be bankruptcy remote to protect against substantive consolidation, being bankruptcy remote has been believed to reduce the risk of consolidation by reducing the risk that the SPE will itself file bankruptcy. Bankruptcy remoteness also reduces the threat of an opportunistic bankruptcy filing by the SPE at the instigation of the Parent intended to frustrate enforcement of the rights of the creditors and other parties to the structured financing. Or at least such was thought to be the case until the *General Growth* bankruptcy where the bankruptcy court ignored the separateness of the SPEs in favor of treating them as a "corporate family" with their Parent. While the bankruptcy court did not actually pierce the veil of the SPEs or substantively consolidate the SPEs with their Parent, the effect of the bankruptcy court's decision came very close to those results.

General Growth Properties, Inc. ("GGP") owns commercial properties throughout the United States and financed its investments with collateralized mortgage backed securities issued by its SPEs. These debt instruments needed refinancing from time-to-time, and the refinancing resulted in fees that kept GGP in operation. Starting in late 2007, the market for these type of financing transactions became weak and then non-existent. GGP itself was in financial distress and in default of some obligations. GGP saw a need for refinancing many of the SPEs over the next couple of years, and perceived it to be impossible to do so. In 2009, GGP and more than

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[113] 15 U.S.C. §548 and §547, respectively.

160 SPEs filed for bankruptcy protection.[114] For the most part these SPEs were solvent, not in financial distress. Creditors moved to dismiss the SPE bankruptcy filings on the grounds that the SPEs were not bankrupt and their filings were in bad faith.

Among their arguments for dismissal of the SPE bankruptcies, the creditors alleged that the SPEs had made a "bad faith" filing of bankruptcy since (for the most part) they were not insolvent prior to filing. The Court noted: "[f]aced with the unprecedented collapse of the real estate markets, and serious uncertainty as to when or if they would be able to refinance the project-level debt, the Debtors' management had to reorganize the Group's capital structure." In an August 11, 2009 opinion denying the motions to dismiss, the Honorable Allan Gropper concluded: "a judgment on an issue as sensitive and fact-specific as whether to file a Chapter 11 petition can be based in good faith on consideration of the interests of the group as well as the interests of the individual debtor."

Judge Gropper went on to permit the assets of the SPEs to be used to finance the parent's operations provided the SPE secured parties were adequately protected as contemplated by the Bankruptcy Code. In doing so, the Court treated the SPEs as part of the "corporate family" and permitted the use of excess cash flow and assets by the entire group. Under the "corporate family" doctrine, the Court treated affiliated companies as a collective whole engaged in a common enterprise. While it stops short of substantive consolidation (and in fact the Court said: "[n]othing in this Opinion implies that the assets and liabilities of any of the Subject Debtors could properly be substantively consolidated with those of any other entity"[115]), this approach is significantly different that the bankruptcy remote status that was thought to exist before GGP and deviates from the treatment of each SPE as a separate entity as the creditors generally expected.[116]

In *General Growth*, the creditors alleged that the SPE bankruptcy filings were in bad faith since the SPEs were not insolvent, and the managers should not have permitted such filings in the circumstances. The SPE operating agreements provided that "[t]o the extent permitted by law… the Independent Managers shall consider only the interests of the Company, *including its respective creditors*, in acting or otherwise voting on the matters referred to in Article XIII (p) [including filing a bankruptcy petition]." The operating agreements also stated that "in exercising their rights and performing their duties under this Agreement, any Independent

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[114] *In re General Growth Properties, Inc.*, 409 B.R. 43, No 09-11977 (ALG) (Bankr. S.D.N.Y. 2009). An earlier (May 14, 2009 opinion) raised the issue that the Court was considering a substantive consolidation of the SPEs with GGP.

[115] See "*Special Report on the Preparation of Substantive Consolidation Opinions*," by the Committee on Structured Finance and the Committee on Bankruptcy and Corporate Reorganization of The Association of the Bar of the City of New York, 64 *The Business Lawyer (ABA)* at 411 (February 2009). In that report, substantive consolidation is defined as where "the assets and liabilities of two or more entities are combined, and the pooled assets are used in the aggregate to satisfy the claims of creditors of the consolidated entities." *Id.* at 413-4.

[116] A subsequent case, *Lehman Brothers Special Financing, Inc. v. BNY Corporate Trustee Services Limited (In re Lehman Brothers Holdings, Inc.)*, 422 B.R. 407 (Bankr. S.D.N.Y. 2010), also avoided substantive consolidation in favor of focusing on the needs of a corporate group to impose a decision affecting creditors of one debtor based on the status of another.

Manager shall have a fiduciary duty of loyalty and care similar to that of a director of a business corporation organized under the General Corporation Law of the State of Delaware." In response to the creditors' claims, the Court noted that the duty of a director of a solvent corporation under Delaware law (and the law of any Model Business Corporation Act state, including Colorado) is to the corporation and its shareholders – not to creditors. Since the SPEs were solvent, the Court found that the managers were justified in considering the best interests of each SPE, GGP and the corporate family and those interests may be paramount to the interest of the creditors of a solvent entity. [There are of course issues with respect to the duties of directors of insolvent entities or entities within the zone of insolvency. Those were not addressed in the opinion but have been addressed elsewhere in cases such as *Gheewalla*[117] (Delaware law), *Anstine*[118] (Colorado law) and their progeny.]

As another example of GGP's bad faith supporting their motions to dismiss, the creditors noted that shortly before filing the bankruptcy petitions, GGP had dismissed the independent managers of the SPEs and replaced them with two other persons who met the operating agreement definition of "independent managers" but who were more favorably inclined to GGP's issues. The former managers did not even learn of their termination until after the bankruptcy filings. In denying this claim, the Court noted that GGP and the SPEs accomplished the termination and appointment of new independent managers in accordance with the operating agreements, and the Court could not reach the conclusion that following the requirements of the operating agreements was evidence of bad faith.

In Colorado and many other states, a limited liability company operating agreement is the agreement of the members and may include as parties other persons, such as lenders.[119] The statutes authorizing limited liability companies are generally contractarian – meaning that the parties to the operating agreements must "scriven with precision."[120]

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117 In *North American Catholic Educational Programming Foundation, Inc. v. Gheewalla*, 930 A.2d 92 (Del. 2007), the Delaware Supreme Court held for the first time that the directors of an insolvent corporation have duties to creditors that may be enforceable in a derivative action on behalf of the corporation. But it rejected the proposition of several earlier Chancery cases that directors of a Delaware corporation have duties to creditors when operating in the "zone of insolvency," stating: "When a solvent corporation is navigating in the zone of insolvency, the focus for Delaware directors does not change: directors must continue to discharge their fiduciary duties to the corporation and its shareholders by exercising their business judgment *in the best interests of the corporation for the benefit of its shareholder owners*." 930 A.2d at 101 (emphasis supplied).

118 *Alexander v. Anstine*, 152 P.3d 497, 498 (Colo. 2007). In footnote 9 to its *Anstine* decision, the Colorado Supreme Court noted the adoption of §7-108-401(5) but expressed "no opinion on whether [§7-108-401(5)] applies where a corporation is insolvent." C.R.S. §7-108-401(5) provides that "A director or officer of a corporation, in the performance of duties in that capacity, shall not have any fiduciary duty to any creditor of the corporation arising only from the status as a creditor."

119 C.R.S. §7-80-102(11).

120 *Willie Gary LLC v. James & Jackson, LLC*, 2006 WL 75309, at *2 (Del.Ch.Ct. Jan. 10, 2006), affirmed *sub nom. James & Jackson, LLC v. Willie Gary LLC*, No. 59-2006 (Del. Sup. Ct. Mar. 21, 2006). There the issue was a dispute resolution clause which the court found was "unwieldy" but sufficiently clear to deny a motion to dismiss for arbitration of the claims. *See, also,* Kleinberger, "*Careful What You With For – Freedom of Contract and the Necessity of Careful Scrivening*" XXIV Pubogram 19 (October 2006), available at http://ssrn.com/abstract=939009.

Following *General Growth*, lenders will probably require SPEs to change their operating agreements to require prior notice pending any change of independent managers, a waiver of fiduciary duties by those managers, and perhaps a contractual definition of those fiduciary duties leading toward the consideration of the interests of creditors over the interest of the parent (provided such waivers do not violate the contractual duties of good faith and fair dealing).[121] For SPEs formed under Colorado law, the creditors may require that they be appointed non-economic members of the LLC and that the vote of the non-economic members be required before the LLC may file a bankruptcy petition.[122] The non-economic membership must be carefully structured to avoid the concern raised with respect to "peppercorn members" in the *Albright* case.

Conclusion

Although the *Sheffield, McCallum* and *Trowbridge* panels that considered the veil piercing issues carefully analyzed the statutes involved, they failed to consider that in 2006 the legislature adopted S.B. 2006-187 which significantly reduced creditors' rights under both the CBCA and the LLC Act:.

> In SB 2006-187, the legislature added § 7-108-401(5) to the CBCA in an effort to insulate directors from creditors' claims.
>
> At the same time, the legislature 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, McCallum* 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 *Ficor* and *Anstine* decisions, both of which served as a basis for the three Court of Appeals decisions. The three panels also assumed the continuing applicability of *Anstine*, even though the Colorado Supreme Court left the question open in *Anstine's* footnote 9.

The *CBRE* panel did not consider the veil piercing issues under the LLC Act because the litigants did not raise the issue. Instead, that panel carefully considered the application of CUFTA, implicitly determining that CUFTA may be a remedy directly against a person receiving a distribution, but for the reasons cited CUFTA was not an appropriate remedy in this case. The CCAA also provides a mechanism to hold equity owners of a Colorado entity liable when they have received liquidating distributions in violation of the operative statutes. The corporate family doctrine of *General Growth Properties* also did not consider piercing the veil

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[121] C.R.S. §7-80-108(2)(d) and §7-80-108(2.5).

[122] Non-economic members are permitted by C.R.S. § 7-80-501.

issues, but rather applied a "reverse piercing" concept,[123] allowing creditors of the parent entity to use the assets of the subsidiary SPE LLCs for the creditors of the parent, as in the single member LLC cases.

In all three Colorado veil piercing cases, it appears that 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. Consequently, it appears that the three panels were intent to find liability of the defendants. In each case, the panels failed to complete their legal analysis in a manner consistent with the statutes, case law, or the legislative history. The courts clearly felt that the facts of the case were sufficiently egregious to apply the equitable remedy of piercing the veil, but this has the effect of a *post-hoc* rationalization[124] – bad things happened and the court needs to find a remedy notwithstanding the plaintiff's failure to plead properly or include the correct parties to the actions.

As shown in *General Growth Properties* and the other single member LLC cases, it has to be assumed that single member LLCs provide limited asset protection for the single member owner. Where there are other interest owners, even non-economic interest owners such as the creditors in *General Growth Properties*, the operating agreement should be written carefully to protect the interests of those other interest owners. Where a true single member LLC is involved (even one with "peppercorn members"), creditors will likely be able to access the assets of the LLC to resolve the owner's liabilities.

The ultimate effect of a continuing application of the doctrine as applied by the *Sheffield* and *Colborne* panels will be to raise concern on the ability of Colorado limited liability companies to protect their owners and managers from liability, not only in outrageous transactions as seen in *Sheffield* and *Colborne*, but in other transactions as well. The willingness of the Court of Appeals to reach decisions that are inconsistent with the statutory guidance and legislative history make Colorado a less attractive jurisdiction in which to form limited liability companies. An analysis under CUFTA, or even remaining true to the statutory language but using the equitable ownership doctrine or the common law limited trustee duty would be preferable for the preservation of the statute as enacted by the General Assembly. Hopefully the Supreme Court will provide some direction (at least for limited liability companies) in its eventual decision in the *Colborne* appeal where will consider the continuing validity of the *Ficor* holding and the limited trustee duty found in *Anstine* and their application to LLCs.

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[123] "Reverse veil piercing" is an approach where creditors of the owner(s) seek payment of the owner's liabilities from entity assets. It is the reverse of "veil piercing" where entity creditors seek payment of the entity's liabilities from the assets of the owner(s). *See* Carter G. Bishop, *Reverse Piercing: A Single Member LLC Paradox*, 54 S.D. L. REV. 199 (2009); Larry E. Ribstein, *Reverse Limited Liability and the Design of Business Associations*, 30 DEL. J. CORP. L. 199 (2005).

[124] Phrase courtesy of Mark Loewenstein, Professor of Law, University of Colorado School of Law, presented in draft article entitled "*Veil Piercing to Non-Owners; A Practical and Theoretical Inquiry*," drafted dated May 24, 2010.

Practice Points – How to Avoid Piercing the Veil

- The principals should not use the entity to assist the principals in lying, cheating or stealing. Under the old legal maxim of "bad facts make bad law," courts are more likely to bend over backwards and ignore the law where the court believes that equity demands relief.

- Maintain formalities where possible or where required by the operating agreement.
  - Formalities (minutes, etc.) are required of corporation.
  - Formalities are required in an LLC where the operating agreement so states.
  - Otherwise, the LLC Act specifically states that a failure to observe formalities relating to management "is not in itself a ground for imposing personal liability on members." C.R.S. § 7-80-107(1).

- Have management manage. Both 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 is likely to do so also.

- Where a limited liability company is established as a single purpose entity 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 is still significant doubt as to the entity's manager's duties to creditors in the "zone of insolvency," not withstanding 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.