



What Does Your Company Do for You?

Limited Liability, Indemnification and Piercing the Corporate Veil

By Laura J. Osborne¹

Corporate forms, whether a traditional corporation or a limited liability company, provide two levels of liability protection for shareholders, directors, officers and key employees: (1) statutory limitations of liability and indemnities; and (2) common law protections against being treated as an “alter ego” of the corporate entity – also known as “piercing the corporate veil.”

For example, members and managers of limited liability companies are generally not personally liable for a debt, obligation, or liability of the limited liability company. C.R.S. 7-80-705. Likewise, a limited liability company is obliged to reimburse a person who is or was a member or manager for payments made, and to indemnify a person who is or was a member or manager for liabilities incurred, in the ordinary course of the company’s business or for the preservation of its business or property, if such payments were made or liabilities incurred without violation of the person’s duties to the company. C.R.S. 7-80-407. Corresponding provisions exist for both for-profit corporations (*see* CRS 7-103-102(o) and 7-108-402 (1)) and non-profit corporations (*see* CRS 7-128-402 and CRS 7-129-101 *et seq.*). Accordingly, the primary distinction between limited liability companies and corporations in this respect is that the statute itself provides the limitation of liability for limited liability companies, but requires the articles of incorporation to set forth limitations of liability and indemnification for corporations.

In certain circumstances, however, a court can look beyond these protections to the individuals that own or operate a corporate entity. This concept is generally referred to as “piercing the corporate veil” and results when an individual or individuals are considered the “alter ego” of the corporate entity.

To determine whether piercing the corporate veil is appropriate, a court must consider three factors.

1. Whether the corporate entity is the alter ego of the shareholder. *In re Phillips*, 139 P.3d 639, 644 (Colo. 2006). A corporation is a shareholder’s alter ego when the

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corporation is a mere instrumentality for the transaction of the shareholder's own affairs, and there is such a unity of interest in ownership that the separate personalities of the corporation and the shareholder no longer exist. *Id.*; *Sheffield Servs. Co. v. Trowbridge*, 211 P.3d 714, 720 (Colo. App. 2009) (overturned on other grounds, see below).

2. Whether justice requires recognizing the substance of the relationship between the shareholder and the corporation over the form because the corporate fiction was used to perpetrate a fraud or defeat a rightful claim. *Phillips*, 139 P.3d at 644.

3. Whether an equitable result will be achieved by disregarding the corporate form and holding the shareholder personally liable for the acts of the corporation. *Id.* Achieving an equitable result is the "paramount goal" of traditional piercing of the corporate veil. *Id.*

Upon "clear and convincing" proof of each of the foregoing factors, a court may ignore the independent existence of the corporate entity and the statutory protections afforded the shareholder, director, officer or key employee, and hold that individual liable for the corporation's actions or obligations. *Id.*

Colorado precedents also recognize that the doctrine may be employed to impose individual liability on non-shareholder corporate insiders, including corporate officers and managers of limited liability companies. See *McCallum Family LLC v. Winger*, 221 P.3d 69 (Colo. App. 2009). In *McCallum*, the Colorado Court of Appeals expanded the piercing the corporate veil doctrine to impose personal liability on an individual who was not a corporate shareholder, but was an "insider", used the corporate form to transact his personal business, and treated the corporate funds as though they were his own. The Court of Appeals stated, "it would elevate form over substance to allow [Winger] to avoid personal liability merely because he has avoided owning stock in his own name and assuming a corporate title such as officer or director." *Id.* at 75.

The doctrine of veil piercing also extends to non-profit corporations. See *Krystkowiak v. W.O. Brisben Cos., Inc.*, 90 P.3d 859, 867 n. 7 (Colo. 2004). In *Krystkowiak*, the Colorado Supreme Court held that the alter ego theory may be applied to "members of a nonprofit corporation."

Limited liability companies are not immune from the "alter ego" theory but it is applied more narrowly. C.R.S. 7-80-107 states:

(1) In any case in which a party seeks to hold the members of a limited liability company personally responsible for the alleged improper actions of the limited liability company, the court shall apply the case law which interprets the conditions and circumstances under which the corporate veil of a corporation may be pierced under Colorado law.

(2) For purposes of this section, the failure of a limited liability company to observe the formalities or requirements relating to the management of its business and affairs is not in itself a ground for imposing personal liability on the members for liabilities of the limited liability company.

Most recently, the Colorado Supreme Court affirmed that the “alter ego” theory applies to individual members and managers, including non-member managers, of limited liability companies, but refused to extend the scope of the statute to create a fiduciary duty of members or managers of an insolvent LLC to its creditors. *Weinstein v. Colborne Foodbotics, LLC*, 302 P.3d 263 (Colo. 2013). The Colorado Supreme Court was careful to note: “An LLC is distinct from a corporation and is not governed by the Colorado Business Corporation Act.... The legislature included corporation common law in only one instance in the LLC Act: in the context of “interpret[ing] the conditions and circumstances under which the corporate veil of a corporation may be pierced...” Ultimately, the Colorado Supreme Court concluded “Section 7-80-107(1) . . . does not imply that the legislature intended to extend a shareholder’s personal liability to an LLC member in all instances. . . . Because LLCs and corporations are different business entities, it is reasonable that the common law applicable to corporations does not apply to an LLC in the context of a claim for unlawful distribution.”

Finally, the Colorado Supreme Court overturned the court of appeals decision in *Sheffield Servs. Co. v. Trowbridge*, 211 P.3d 714, 723-24 (Colo. App. 2009), holding that the logic of Section 7-80-107(1) extended to a veil-piercing claim against an LLC member to impose personal liability on LLC members under the common law trust doctrine. The Colorado Supreme Court stated “because the LLC Act does not extend the corporation common law to an LLC in any instance except a veil-piercing claim, the court of appeals in *Sheffield* erred in extending the fiduciary duty an insolvent corporation’s directors owe its creditors to the managers of the LLC.”

As numerous cases and commentators have established, the corporate veil may be pierced and the corporation treated as an alter ego:

- where the corporate form has been abused;
- where the corporate entity has been used as a deception and to observe it would work an injustice;
- where the party sought to be held liable has dominance and control over the corporation and uses the corporate entity as a mere instrumentality for the transaction of that party’s own affairs;
- where there is such a unity of interest and ownership that the separate personalities of the corporation and the party do not exist; and
- where to allow the corporate fiction to persist would promote injustice or protect fraud.

Where the party to be held liable exercises an extensive level of control over the corporation, such control may be an important factor in determining whether to pierce the veil. Domination and control, however, should be addressed as a threshold question. If they are found to exist, the analysis can proceed to the issue of whether the domination was used for an improper purpose.

Since Colorado has expanded the reach of common law veil piercing to include not only members but managers as well, real estate practitioners should also be aware of a recent California Court of Appeals decision extending the common law doctrine of veil piercing to situations where limited liability companies are used for specific projects or purposes. In *Asphalt Professionals, Inc. v. Bock*, 2011 WL 1124401 (Cal.App. 2 Dist., Unpublished, Mar. 29, 2011), the California Court of Appeals considered whether a defendant's business practice of setting up, using, then disbanding LLCs for each development might actually be an alter ego "conduit for a single venture." (citing *Zoran Corp. v. Chen*, 185 Cal.App.4th 799, 811 (Cal.App. 2010)). Since use of limited liability companies by developers for each project or property is pervasive in Colorado and elsewhere, practitioners should be aware that this business practice may actually create a new avenue to enable or facilitate piercing the corporate veil of an LLC. The full opinion in the *Asphalt Professionals, Inc.* case can be found at <http://goo.gl/ILoKc>.

The most obvious way around a veil piercing claim is to ensure that the basic elements of "alter ego" test are not satisfied: each corporate entity should adequately funded, it should be managed separately for other corporate entities, and its funds and operations should not be commingled with other related corporate entity's funds and operations.