Sedgwick Props. Dev. Corp. v. Hinds
An LLC Is Not A Corporation

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I have previously discussed piercing the veil of corporations and limited liability companies a number of times in the CBA's Business Law Section newsletter. I have frequently found the Courts' decisions to be seriously wanting. We now have one that is mostly correct.

Colorado Court's Prior Misapplication of Corporate Law to LLCs

Sheffield, McCallum, and Colborne. In November 2009, I discussed *Sheffield Services Company v. Trowbridge*, 211 P.3d 714 (Colo. App. 2009) where I commented that "Contrary to the statutory guidance [in § 7-80-705], the [Court of Appeals] Panel held that a non-member manager of a limited liability company (an 'LLC') could be held liable to a creditor under a piercing the corporate veil theory." Section 7-80-107 then and now clearly provides for the possibility of applying the corporate remedy of piercing the veil "to hold the members of a limited liability company personally responsible" in the appropriate circumstances. A month later I discussed *McCallum Family LLC v. Winger*, 2009 WL 3465332 (Colo. App. 10/29/2009), where I stated that the Court of Appeals "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." Two months later in the February 2010 newsletter, I wrote about *Colborne Corporation v. Weinstein*, 2010 WL 185416 (Colo. App. 1/21/2010). The Court of Appeals panel again ignored the Colorado Limited Liability Company Act ("Colorado LLC Act"), holding that only the LLC in question could bring an action for a distribution that violated the provisions of C.R.S. § 7-80-606." There the panel misinterpreted corporate law and thereby misread the Colorado LLC Act. In the *Colborne* article I concluded that "The effect of these three decisions is clear – the Court of Appeals will attempt to protect creditors of insolvent entities if it believes that the officers, directors, managers, or members are treating creditors unfairly. While this may be good public policy if it is what the legislature intended, the analyses that the three different panels have followed to reach this result do not make the law very clear. In each case, the Court is reinterpreting the applicable statutes to make what it believes to be a 'right' decision rather than accepting the plain meaning of the legislature's statutory words."

Fortunately, and as discussed in the June 2013 newsletter, in *Weinstein v. Colborne Foodbotics, LLC*, 2013 CO 33 (June 10, 2013), the Supreme Court reversed the Court of Appeals' *Colborne* decision, specifically overruled the 2009 *Sheffield Services* opinion, and (as I stated in that newsletter) found that "LLCs are not corporations, and it is improper to apply corporate law to LLCs except in the one instance (piercing the veil in C.R.S. § 7-80-107(1)) where the application of corporate law to LLCs was mandated by statute."

Martin v. Freeman and Stockdale v. Ellsworth. Unfortunately, courts have gotten this distinction wrong more often than not. In the February 2012 newsletter, I discussed the

Colorado Court of Appeals' decision in *Martin v. Freeman*, 2012 COA 21 (Colo. App. 2012) where the court applied Colorado law to a limited liability company formed under Delaware law. This was another decision which I concluded "to have been result-driven," raising questions in Colorado about the adequacy of an LLC to provide liability protection to its members. The CBA Business Law Section newsletter included another article I wrote about piercing an LLC veil, entitled *Wrong Law Applied, Wrong Words Used, But the Correct Result Reached.* This article was about *Stockdale v. Ellsworth*, 2017 CO 109 (Dec. 18, 2017), a Colorado Supreme Court case that approved the application of Colorado law to a Wyoming limited liability company (wrong law) to pierce the "corporate veil" (wrong words), and find the principal liable (arguably the right result under the facts set forth and a correct application of the law). In that article I pointed out that Colorado, like most other states, has adopted the "internal affairs" doctrine which provides that "As to any foreign entity transacting business or conducting activities in this state, the law of the jurisdiction under the law of which the foreign entity is formed shall govern the organization and internal affairs of the foreign entity and the liability of its owners and managers." C.R.S. § 7-90-805(4). Thus, the court should have looked to Wyoming law, and specifically Wyo. Stat. § 17-29-304. I expressed my belief that a Colorado court applying Wyoming law would have likely imposed liability on Ellsworth, but complained that "the Colorado courts did not even consider the applicability of Wyoming law" any more than the *Martin v. Freeman* court considered the application of Delaware law.

Gagne v. Gagne. In April 2019, I wrote another article about the Court of Appeals wrongly applying corporate law to a limited liability company. This article, entitled *Your Honor – An LLC Is Not A Corporation – Mr. and Ms. Litigator, Your Help Is Needed*, discussed a mother-son dispute in *Gagne v. Gagne*, 2019 COA 42 (March 21, 2019). There the son sought judicial dissolution of an LLC that he co-owned with, but was controlled by, his mother. The Court of Appeals reached the conclusion that as the sole manager, the mother materially breached her duties and dissolution was warranted. Unfortunately, the Court of Appeals went on unnecessarily from there to discuss the mother's breach of the corporate business judgment rule in her actions as manager of the LLC:

> "The [business judgment] rule arose in the corporate context. **We assume** it applies in the limited liability company context as well." [Emphasis supplied.]

As I noted in that newsletter, "the business judgment rule does not apply to LLCs unless it is specifically incorporated into the [LLC's] operating agreement." In that newsletter, I concluded that:

> I am of the opinion that the Court of Appeals did not need to apply the corporate business judgment rule in order to reach its conclusion that Paula's actions violated her duties as manager of the four LLCs. By doing so in a reported opinion, the Court creates a bad precedent for future decisions looking at Gagne II for guidance.
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> Much of this bad law is not the sole responsibility of the courts. Our hard-working judges have to devote their attention to many areas of the law: criminal, commercial, family, personal injury, tax, real estate, business entities, etc. No person can be an expert in all of these areas, or even in a few.

> The litigators presenting these cases have an obligation to develop an expertise in the laws they are presenting to the courts, and to explain them clearly and honestly. Or to use an expert within their own firm or an outside expert to do so.

Today's Topic: Sedgwick Props. Dev. Corp. v. Hinds.

In July 2019, the Court of Appeals issued another decision finding that a single-member, single-purpose LLC was entitled to its statutory limited liability and the pure corporate analysis for piercing the veil to find alter ego liability were not applicable. This case, *Sedgwick Props. Dev. Corp. v. Hinds*, 2019 COA 102 (July 3, 2019), resulted from a district court finding that a developer services corporation that had contracted with a single-member, single-purpose LLC was the alter ego of the LLC for purposes of piercing the veil of the single-member LLC. Although frequently referring to the "corporate veil" of the LLC, the Court of Appeals analysis otherwise was quite good. In this case, 1950 Logan, LLC (a manager-managed Colorado LLC) was found liable for a significant judgment. The beneficiary of that judgment, plaintiff Hinds, was unable to collect from 1950 Logan (which had completed its business and was delinquent on the records of the Secretary of State from October 1, 2008), so he brought suit against Sedgwick Properties – a contractual manager of 1950 Logan, not a statutory manager of the LLC.

The analysis starts with the finding that "[a] duly formed corporation is treated as a separate legal entity, unique from its officers, directors, and shareholders" (citing *In re Phillips*, 139 P.3d 639, 643 (Colo. 2006)). Further citing to *Phillips*, the Court of Appeals went on to admit that "[t]he fiction of the corporate veil isolates 'the actions, profits, and debts of the corporation from the individuals who invest in and run the entity.' . . . Only extraordinary circumstances justify disregarding the corporate entity to impose personal liability."

Burden of Proof – Preponderance of the Evidence. The Court of Appeals then discussed certain of the cases previously decided for piercing the veil of a corporation and decided that the burden of proof for establishing the elements for piercing the veil was "by a preponderance of the evidence" (citing C.R.S. § 13-25-127(1)).

An LLC Is Not A Corporation. In the decision, the Court of Appeals noted that "single-member LLCs are permitted by statute, [citing C.R.S. § 7-80-204(1)(g)], and may be formed for any lawful business purpose [citing C.R.S. § 7-80-103]." The Court of Appeals identified the "legal underpinnings of alter ego analysis" by reference to *In re Phillips* and other corporate cases, and then found the:

> "***statutory basis for different treatment of limited liability companies in the veil-piercing context.***" [emphasized and highlighted because of its importance.]

The Court of Appeals criticized the district court, saying that its veil piercing "analysis foundered, however, on the assumption that a single-member, single-purpose LLC is subject to the same veil-piercing analysis generally applied to corporations, without taking into account the characteristics of such LLCs" – citing specifically to C.R.S. § 7-80-107. Citing Colorado lawyer extraordinaire Robert Keatinge (*Ribstein and Keatinge on Limited Liability Companies* § 15.3),

the Court of Appeals noted that "a court determining whether to pierce the corporate veil of an LLC must tread carefully and must consider whether traditionally applied veil-piercing factors are applicable in the context of such a company." In this case, Sedgwick was a contractual manager of 1950 Logan and "actually had no interest in Logan." According to the Court of Appeals:

> Sedgwick was hired under a contract to manage 1950 Logan . . . . The [trial] court's findings do not show control by Sedgwick beyond what would be expected under the contractual role of manager of the LLC. . . . The [trial] court's ruling appears to ignore . . . other evidence that would tend to show that Sedgwick did *not* exercise control over 1950 Logan beyond what would be expected under its contractual management agreement.

The Court of Appeals found that "in the context of a single-member LLC – and particularly one that is run under contract with a management company – we conclude that these factors [not having a board of directors; no evidence of board of director approval; no minutes of board meetings in 1950 Logan] do not weigh in favor of finding alter ego status."

> "LLCs are often operated with less formality [than traditional corporations] and may not have regular meetings of members or managers, or observe other procedures that are required for corporations. . . . As an example, the Colorado Business Corporation Act requires corporations to hold annual meetings of shareholders under section 7-107-101. There is no similar requirement for annual meetings of the members of an LLC under the LLC Act."

(citing 1 Stephen A. Hess, *Colorado Practice Series: Methods of Practice* § 5.9, Westlaw (8th ed. database updated May 2019). After reviewing some other mistakes in application of entity law made by the trial court, the Court of Appeals concluded "that the evidence presented to the district court is insufficient to establish, even by a preponderance of the evidence, that 1950 Logan is the alter ego of Sedgwick. Therefore, the elements necessary for piercing the corporate veil cannot be met."

The Court of Appeals accurately and correctly reads C.R.S. § 7-80-107(3) when it found that the fact that 1950 Logan, as a single member LLC disregarded for tax purposes, does "nothing to establish *Sedgwick* as the alter ego of 1950 Logan." C.R.S. § 7-80-107(3) clearly provides that a "limited liability company's status for federal tax purposes does not affect its status as a distinct entity organized and existing under" the Colorado LLC Act.

Conclusion

Although the Court of Appeals referred too often to the "corporate veil" when discussing the single-member LLC, the Court of Appeals properly analyzed the statute and the use, in general, of LLCs as a more informal entity than is a corporation. While this was a decision for a single-member LLC, its analysis should also apply to multi-member LLCs – except in cases where the operating agreement imposes a formalistic structure to the operation of the LLC.

In that case, and as we say in Lidstone and Sparkman, *Limited Liability Companies and Partnerships in Colorado* (CLE in Colo. 2019) at n. 58, page 750, where the operating agreement establishes formalities for the LLC, members and courts will expect the LLC to follow those formalities. Why would you establish those formalities for an LLC unless the LLC plans to follow them? Too many LLCs do so because they use a form agreement without thinking about the consequences.

Persons creating LLCs under Colorado law should take the time and expend the funds necessary for a well-thought-out operating agreement rather than blindly using someone else's form.