

NBI SEMINAR

TOP LLC MISTAKES TO AVOID IN EVERYDAY BUSINESS PRACTICES

SECTION 4: LLC VEIL PIERCING: MISTAKES MADE IN EVERYDAY PRACTICE THAT EXPOSE PERSONAL LIABILITY

(MAY 21, 2015)

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INTRODUCTION

Piercing the LLC veil is statutory as opposed to the corporate veil piercing doctrine which was established by judicial decision. RCW 25.15.060 below specifically incorporates the Washington corporate veil piercing doctrine.

RCW 25.15.060

Piercing the Veil.

Members of a limited liability company shall be personally liable for any act, debt, obligation, or liability of the limited liability company to the extent that shareholders of a Washington business corporation would be liable in analogous circumstances. In this regard, the court may consider the factors and policies set forth in established case law with regard to piercing the corporate veil, except that the failure to hold meetings of members or managers or the failure to observe formalities pertaining to the calling or conduct of meetings shall not be considered a factor tending to establish that the members have personal liability for any act, debt, obligation, or liability of the limited liability company if the certificate of formation and limited liability company agreement do not expressly require the holding of meetings of members or managers.

Note the last sentence of the statute. One of the prime reasons regarding choice of entity is that a LLC requires less formalities than a corporation. This statute requires that the Certificate of Formation and Company Operating Agreement must not require the formalities of meetings of members or managers. In a single-member LLC that would be acceptable in my opinion, but in a multi-member LLC, it could be foolhardy to not require Member and/or Manager meetings and could lead to secrecy and potential breach of duty complaints. You are advised to discuss this with your client.

PIERCING THE CORPORATE VEIL

In order to pierce the corporate veil, two separate, essential factors must be established: first, the corporate form must be intentionally used to violate or evade a duty. Second, the fact finder must establish that disregarding the corporate veil is necessary and required to prevent an unjustified loss to the injured party. *Dickens v. Alliance Analytical Laboratories, LLC*, 127 Wn. App. 433, 111 P.3d 889 (2005), citing *Meisel v. M&N Modern Hydraulic Press Co.*, 97 Wn.2d 403, 645 P.2d 689 (1982). Whether or not the corporate veil may be pierced is a question of fact. *Truckweld Equipment Co., Inc., v. Olson*, 26 Wn. App. 638, 618 P.2d 1017 (1980).

Typically, the injustice which dictates a piercing of the corporate veil is one involving fraud, misrepresentation, or some form of manipulation of the corporation to the stockholder's benefit and the creditor's detriment. See *Truckweld Equipment Co., Inc. v. Olson*, citing *Morgan v. Burks*, 93 Wn.2d 580, 611 P.2d 751 (1980).

LLC VEIL PIERCING CASE DECISIONS

The leading case is *Landstar Inway Inc. v. Samrow*, 181 Wn. App 109, 325 P.3d 327 (2014).

The Court of Appeals began its review of Washington's LLC veil-piercing law by referring to *Chadwick Farms Owners Association v. FHC, LLC*, 166 Wn.2d 178, 207 P.3d 1251 (2009), and Section 25.15.060 of the Washington LLC Act. To succeed in piercing the veil of an LLC, a plaintiff must prove that the LLC form was used to violate or evade a duty and that the LLC form should be disregarded to prevent loss to an innocent party. Abuse of the corporate form must be shown to establish that the LLC was used to violate or evade a duty, and that typically involves some type of fraud, misrepresentation, or manipulation of the LLC to the member's benefit and the creditor's detriment, *Landstar. Id.* at 123.

Landstar alleged that Samrow abused the corporate form by fraudulently concealing the fact that Oasis dispatched pilot car operators instead of providing pilot car services of its own, and by fraudulently misrepresenting his own personal insurance as Oasis', to satisfy Oasis's insurance obligation under the master agreement. But Samrow argued that the court should reject Landstar's veil-piercing claim because it was based on fraud, and Landstar failed to plead

the elements of fraud and the factual circumstances with the particularity required by Civil Rule 9(b).

The court pointed out that it was faced with an issue of first impression: “There is no Washington case addressing whether a party must satisfy the pleading requirements of CR 9(b) in seeking to disregard a corporate form.” *Id.* at 125. The court looked to the federal courts because they have addressed the issue, but found no unanimity there.

Washington law is clear that piercing the veil is an equitable remedy and not a separate cause of action. If the veil of an LLC is pierced, a member may be held personally liable for the LLC’s underlying tort or breach of contract, but piercing the veil is not a freestanding claim for relief. *Id.* at 125-26 (citing *Truckweld Equip. Co. v. Olson*). From that premise the court reasoned that CR 9(b)’s heightened pleading requirement for claims of fraud should not apply to claims seeking the remedy of piercing the veil, even if the veil-piercing claim is based on fraudulent conduct. The court also noted that its conclusion was consistent with Washington’s commitment to maintaining liberal pleading standards. *Id.* at 126.

Samrow’s mistakes opened up the causeway for Landstar to pierce its LLC veil and personal liability of its Members. To determine the propriety of piercing the veil of the LLC form to impose liability on LLC members, the *Landstar* case held that in establishing that the LLC form must be disregarded to prevent loss to an innocent party, requires the plaintiff to show that disregarding the LLC form is necessary to avoid the consequences of intentional misconduct harmful to the plaintiff. Courts also employ the same test used to determine the propriety of piercing the veil of the corporate form to determine the propriety of piercing the veil of the limited liability company (LLC) form to impose liability on LLC members. Just as the courts may disregard the separate existence of a corporation to impose personal liability on the corporation’s shareholders, courts may disregard the limited liability company (LLC) entity to impose a personal liability on the LLC’s members under certain circumstances.

ANTI-KICKBACK STATUTE – RCW 74.09.240 AND RCW 51.48.280

Genuine issue of material fact existed as to whether member of limited liability company (LLC), which company was a member of employer, which was also an LLC, was personally liable under “anti-kickback” statute, which prohibits employers and employer agents from willfully and intentionally depriving employees of wages, for employees’ unpaid wages, through

piercing the veil of his LLC, precluding cross-motions for summary judgment in employee's action against employer and member as individual. *Dickens v. Alliance Analytical Laboratories, LLC*, 127 Wn. App. 433, 111 P.3d 889 (2005), reconsideration denied.

VIOLATION OF DUTY

Under the test to determine the propriety of piercing the veil of the limited liability company (LLC) form to impose liability on LLC members, a plaintiff must prove that the LLC form was used to violate or evade a duty and to show an abuse of the LLC form and that the LLC form must be disregarded to prevent loss to an innocent party. See *Landstar Inway Inc. v. Samrow*.

FRAUD OR MISREPRESENTATION

Common law fraud falls within the ambit of fraud, misrepresentation, or manipulation constituting an abuse of the LLC form and thus may warrant piercing the veil of the LLC form to impose liability on LLC members. See *Landstar Inway Inc. v. Samrow*.

PRESUMPTIONS AND BURDEN OF PROOF

To pierce the veil of the LLC so that liability can attach to a member, a plaintiff must show that the LLC form was used to violate or evade a duty and that the LLC form must be disregarded to prevent loss to an innocent party. *Chadwick Farms Owners Ass'n v. FHC LLC*, 166 Wn.2d 178, 207 P.3d 1251 (2009), corrected, reconsideration denied.

OTHER MISTAKES MADE TO PIERCE THE CORPORATE/LLC VEIL

1. Consumer Protection Act Personal Liability under Responsible Corporate Officer Doctrine

The responsible corporate officer doctrine purports to impose liability on individuals acting on behalf of a business entity when their conduct "justifies personal liability." An early case to hold officers of a corporation personally liable for intentional torts of the corporation was *Johnson v. Harrigan-Peach Land Development Co.*, 70 Wn.2d 745, 489 P.2d 923 (1971). The trial court found that, in addition to the corporation's own liability, its officers were personally

liable for the misrepresentations because the officers had instructed the sales agents on the false representations to be made and approved the sales literature containing the falsehoods.

The rule announced in *Johnson* was extended to liability under the Consumer Protection Act in *State v. Ralph Williams' N.W. Chrysler Plymouth, Inc.*, 87 Wn.2d 298, 317-18, 553 P.2d 423 (1976). The case again concerned false statements in sales practices, but this time, the CPA was pled. The evidence at trial demonstrated that the entire sales program was designed to deceive customers based on known falsehoods and classic bait-and-switch tactics.

Regarding the owner/manager's personal liability, the Supreme Court relied on *Johnson* to impose joint and several liability on Ralph Williams personally. The Supreme Court remarked that "participating" or "approving" the wrongful conduct justified individual liability. The Supreme Court expanded the responsible corporate officer doctrine to include liability under the Washington Consumer Protection Act (CPA). This development suggests two concerns for individuals. First non-intentional conduct can lead to liability. The CPA requires "neither intent nor actual deception". Second, an act that alone is not deceptive may lead to liability when the conduct of other actors is also considered. Deceptive acts or practices under the CPA are not always comprised of distinct conduct, but can be a series of actions that examined together are capable of deceiving the public.

UNFAIR AND DECEPTIVE PRACTICES

In *Grayson v. Nordic Constr. Co.*, 92 Wn.2d 548, 554, 599 P.2d 1271 (1979), where an advertising brochure was found unfair and deceptive under the CPA, the business's president, manager, director, and majority stockholder who had authored the brochure and directed its mailing was found personally liable under the CPA.

ACTIONS IN VIOLATION OF A STATUTE

In *State Dept. of Ecology v. Lundgren*, 94 Wn. App. 236, 791 P.2d 948 (1999), for example, a business owner was held liable for violating Washington's water pollution control act (RCW 90.48), when his sewage treatment plant spilled.

The *Lundgren* Court then outlined application of personal liability for violations of federal regulations before concluding that violations of Washington's water pollution control act warranted personal liability. Based on the owner's "hands-on control of the facility's activities"

and control of corporate conduct, the court held he “could be deemed an active participant in the conduct.

“Responsible Corporate Officer” Doctrine

APPLICATION TO LLC ENTITY

A recent unpublished Division I case affirmed personal CPA liability against LLC members without discussion of the issue. *Plumb Serve, LLC v. Scoby*, 2012 Wash. App. LEXIS 1847. While a future case might expressly resolve whether the responsible corporate officer doctrine applies to LLC members, the body of case law should be considered when LLC members are involved. The responsible corporate officer doctrine is different from imposing liability based on piercing the corporate veil. It simply depends on evidence of the personal acts of the individuals involved.

WRONGFUL WITHHOLDING OF WAGES

In *Durand v. HIMC Corp.*, 214 P.3d 189 (2009), the Washington State Court of Appeals has upheld a judgment for willful withholding of wages that was entered against both the employer corporation and two of its corporate officers. The Court rejected the officers’ arguments that insufficient funds, the corporate veil and the business judgment rules shielded the officers from personal liability for amounts undisputedly owed. *Durand v. HIMC Corp.*, No. 37088-3-11 Wash. Ct. App. (Aug 25, 2009). The Court also affirmed the trial court’s rulings holding that the corporate employer breached its employment contract with the plaintiff as to disputed amounts for severance, a relocation payment, and a year-end bonus.

The appellate court first reviewed Washington’s wage payment law, which provides, in relevant part, “any employer or officer, vice principal or agent . . . who willfully and with the intent to deprive the employee any part of his wages . . . shall be guilty of a misdemeanor.” RCW 49.52.050. A plaintiff can file a claim for twice the amount of wages unlawfully withheld, attorneys’ fees and costs when he can show a violation of the wage payment law. He cannot recover, however, if he “knowingly submitted to such violations.” RCW 49.52.070.

Like the Washington Supreme Court’s recent ruling in *Morgan v. Kinen and Switzer*, 210 P.3d 995 (2009) and *Schilling v. Radio Holdings, Inc.*, 136 Wn.2d 152, 961 P.2d 371 (1998), this case reaffirms that officers who choose not to pay Washington employees’ wages,

even in difficult financial times, do so at their personal financial peril. Officers may be unable to defend a decision to withhold wages based on either an inability to pay or traditional corporate defenses. *Durand* and *Morgan* illustrate the willingness of Washington courts to look beyond corporate formalities to ensure that employees asserting wage claims can obtain relief, even if that relief comes from the personal resources of individual officers.

CONDOMINIUM ASSESSMENTS

RCW 64.34.364 provides that condominium owners are personally liable for past due assessments. It is a popular tax and limitation of liability planning device to hold condominium unit(s) in a limited liability company(s). However, the homeowners' association may be able to pierce the LLC veil to hold the member(s) personally liable for the assessments.

DISREGARD OF SEPARATION BETWEEN LLC AND MEMBER

The disregard of separation is a basis for a finding of (1) abuse or disregard of the corporate entity causing harm to the party seeking relief and (2) the intentional violation or evasion of a duty (arising from common law and equity, contract or statute) to the party seeking relief to prevent an unjustified loss to pierce the LLC veil by the court exercising its equitable powers.

The Court in *Hiller Corp. v. Port of Port Angeles* 96 Wn. App. 918, 925 (1999) cited the following examples of "Duty:"

"[D]uty may arise from common law and equity contract or statute." *Morgan Bros., Inv. v. Haskell Corp.*, 24 Wn. App. 773, 778, 604 P.2d 1294 (1979) (Quoting Charles Horowitz, *Disregarding the Entity of Private Corporations*, 15 WASH. L.REV. 1, 11 (1940). In *J.I. Case Credit Corp v. Start*, 64 Wn.2d 470, 478, 392 P.2d 215 (1964), the corporate forms of a machinery manufacturer and its wholly owned financing corporation were disregarded to enforce a contract warranty to the machinery purchaser. In *Culinary Workers & Bartenders Union No. 596 v. Gateway Café, Inc.*, 91 Wn.2d 353, 366-67, 588 P.2d 1334 (1979), 642 P.2d 403 (1982), the corporate form was disregarded to enforce a contract between the disregarded corporation and a union. In *Morgan Bros.*, although not discussed, the duty owed was based upon a personal injury tort judgment against the corporation. See *Morgan Bros.*, 24 Wn. App. at 774, 778-79.

BREACH OF SPECIFIC DUTIES

In *Hiller Corporation* above, the duty under the lease to pay rent or misrepresentation or manipulation of financial reports or misrepresentation as to the assignment of a security interest,

duty has been found in favor of a creditor and the corporate form disregarded where necessary to prevent fraud on the creditor (depletion of assets). See *Roderick Timber Co. v. Willapa Harbor Cedar Products, Inc.*, 29 Wn. App. 311, 315. 627 P.2d 1352 (1981).

ALTER EGO THEORY

The Alter Ego Theory is reorganized in Washington and by the Ninth Circuit Court of Appeals. The theory is distinct but analogous to piercing the LLC veil statutory. The Federal District Court in New York granted summary judgment to pierce the veil of a Delaware limited liability company in *Soroof Trading Development Co. Ltd. v. GE Fuel Cell Systems LLC*, No. 10 Civ. 1391(LTS)(JCF), 2012 WL 209110 (S.D.N.Y. Jan. 24, 2012). The court found the LLC to be the alter ego of its members, but did not explain how Delaware's requirement of unfairness or injustice was met. Soroof sued the LLC and its two members for breach of the distribution agreement, misrepresentation, conversion, imposition of a constructive trust, unjust enrichment, and an accounting.

Soroof claimed that the LLC's veil should be pierced, which would enable Soroof to pursue its claims against the LLC's two members. The court stated the rule as follows:

Delaware law permits a court to pierce the corporate veil where there is fraud or where [the corporation] is in fact a mere instrumentality or alter ego of its owner . . . To prevail under the alter-ego theory of piercing the veil, a plaintiff need not prove that there was actual fraud but must show a mingling of the operations of the entity and its owners plus an overall element of injustice or unfairness. (Quoting *NetJets Aviation, Inc. v. LHC Commc'ns LLC* 537 F.3d 168, 177 (2d Cir. 2008)).

The Court recited the alter ego factors to be considered (capitalization, solvency, payment of dividends, adequate records, functioning officers and directors, other corporate formalities, siphoning funds off, and the entity functioning as a "façade" for the owner), and pointed out that less emphasis should be placed on LLC formalities than on corporate formalities.

The Court then described the undisputed facts relevant to piercing GE Fuel Cell Systems LLC's veil:

- The LLC had no cash assets at the time of the dissolution.
- The LLC had no employees, and the individuals working at the LLC were actually employees of the members.
- The LLC did not lease its office space but used the premises of its members.
- There was no sign on the LLC's premises indicating its presence.

After describing these factors, the court simply stated that "Plaintiff's uncontroverted proffers demonstrate an extensive "mingling of the operations" of [the LLC] and its owners, such that [the LLC] was a mere instrumentality or alter ego of GE Microgen and Plug Power, as well as an overall element of unfairness to Sorooof.

Mistakes, intentional or unintentional, can be the cause of piercing the LLC veil. I have outlined the Washington statute, case decisions, legal theories, equitable touch stones and multiple examples of mistakes leading to personal liability of the member(s) or manager(s). You need to advise your clients to be diligent in the governance and business of their LLCs.

LIST OF EXHIBITS

- Exhibit 1 ***Landstar Inway Inc. v. Samrow***, 181 Wn. App. 109, 325 P.3d 327 (2014)
- Exhibit 2 ***Dickens v. Alliance Analytical Laboratories, LLC***, 127 Wn. App. 433, 111 P.3d 889 (2005)
- Exhibit 3 ***Chadwick Farms Owners Association v. FHC, LLC***, 166 Wn.2d 178, 207 P.3d 1251 (2009)