



May 28, 2009

**Re: Potential Liability for LLC Members**

Dear Friends:

On May 14, 2009, the Washington Supreme Court issued an important ruling on the capacity of a Washington limited liability company (“LLC”) to sue and be sued following dissolution or cancellation of an LLC, with potential ramifications for personal liability of LLC members and managers. ***The Court held that individual LLC members may be held personally liable for legal obligations incurred by LLCs, if the LLC is dissolved without adequate provisions being made to satisfy the LLC’s potential liabilities.*** In view of this case, it is incumbent upon individual LLC members and managers to pay careful attention to the following:

- Properly dissolving, winding up the affairs of and canceling an LLC to avoid potential personal liability of individual LLC members.
- Alternatively, continuing the existence of the LLC until the applicable statutes of limitations and statutes of repose have expired.
- Maintaining insurance coverage to protect the LLC and its individual members and managers against potential liabilities, and understanding what is and what is not covered by insurance.
- Setting aside reserves to pay for contingent, conditional, or unmatured claims and obligations that are not covered by insurance.
- Ensuring effective defense, indemnity and hold harmless provisions in contracts.

**The Chadwick Farms and Emily Lane Projects**

The case is *Chadwick Farms Owners Association v. FHC, LLC*, No. 80450-8 (Wash. May 14, 2009) (“Chadwick Farms”), which reverses, in part, contrary decisions made by the Washington Court of Appeals in two real estate development projects, *Chadwick Farms*,<sup>1</sup> and *Emily Lane*.<sup>2</sup>

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<sup>1</sup> *Chadwick Farms Owners Association v. FHC, LLC*, 139 Wn. App. 300, 160 P.3d 1061 (2007), review granted, 163 Wn.2d 1021 (2008).

<sup>2</sup> *Emily Lane Homeowners Association v. Colonial Development, LLC*, 139 Wn. App. 315, 160 P.3d 1073 (2007), review granted, 163 Wn.2d 1022 (2008).

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### **Good News: Properly Dissolving and Canceling an LLC Can Leave a Plaintiff with No Entity to Sue**

In the *Chadwick Farms* project, a developer formed FHC, LLC to develop the Chadwick Farms condominiums. Upon completion of the project, the LLC ceased operations and did not pay license fees or file annual reports required by statute. Consequently, the Washington Secretary of State administratively dissolved FHC, LLC. Although FHC, LLC had been dissolved, the Chadwick Farms Owners Association (“Chadwick Farms HOA”) sued the LLC for construction defects. While the lawsuit was pending, the Washington Secretary of State canceled the LLC’s certificate of formation because it had not applied for reinstatement within two (2) years after dissolution. Despite this, the LLC filed third-party complaints against its subcontractors and design professionals to pass-through the HOA’s claims. The Washington Supreme Court held that FHC, LLC was barred from bringing any claims because it was no longer legally in existence and lacked the capacity to bring affirmative claims for relief. Similarly, the Court upheld the lower court’s dismissal of the HOA’s claims against the LLC under the theory that no LLC existed to be sued.

In the *Emily Lane* project, a developer formed Colonial Development, LLC to develop and sell the Emily Lane condominiums. Upon completion of the project, the LLC members voted to dissolve the LLC and filed a certificate of cancellation with the Secretary of State. Shortly thereafter, the Emily Lane Townhomes Condominium Association (“Emily Lane HOA”) filed suit against the LLC and also asserted claims against the individual LLC members, asserting improper winding up of the LLC, fraudulent concealment, negligent and fraudulent misrepresentation, and seeking to pierce the “corporate veil” of the LLC. The Supreme Court held that the HOA could not sue the LLC because it had been canceled by the time the lawsuit was brought.

### **Bad News: Improperly Dissolving and Canceling an LLC Can Create Personal Liability for LLC Members**

Despite the fact that the developer LLCs were not subject to suit in both the *Chadwick Farms* and *Emily Lane* projects, the Supreme Court held that the individual members of the canceled LLCs could be subject to personal liability for failing to properly dissolve the LLCs and make adequate provisions for potential construction defect claims. Although the Supreme Court acknowledged that LLC members are generally not personally liable for debts of the LLC, it also noted that there are exceptions to this general rule.

In the *Chadwick Farms* project, individual members were potentially liable because the LLC did not pay or make provision for paying the claims asserted by the HOA, even though the LLC clearly knew of the claims during the dissolution period and prior to the Secretary of State’s cancellation of the LLC. The court reasoned the LLC could have sought reinstatement, which would have allowed the LLC to defend against the claims and properly assert claims against the LLC’s subcontractors and design professionals. Having failed to either seek reinstatement of the

LLC or otherwise provide for resolution of the known claims by the HOA, the Court reasoned that the individual members of the LLC could be personally liable on those claims.

Similarly, in the *Emily Lane* project, the Court reasoned that the individual LLC members could be personally liable for improper winding up of the LLC, as well as fraudulent concealment, negligent and fraudulent misrepresentation and liability under the theory of piercing the veil of the LLC.

### **Distinction between Dissolution and Cancellation of an LLC**

The Supreme Court emphasized the distinction between dissolution and cancellation of the LLC in reaching its decision. Dissolution does not terminate the existence of the LLC. Instead, dissolution begins a period in which the members must wind up the affairs of the LLC, including liquidating assets, paying creditors and distributing any proceeds to the LLC members. During dissolution, an LLC still has the power to prosecute and defend lawsuits.

Following dissolution, the LLC's certificate of formation will be  *canceled*  either through the filing of a formal certificate of cancellation by the LLC members, as was done in the *Emily Lane* project, or by the Secretary of State if the LLC does not seek reinstatement within two (2) years of dissolution, as happened in the *Chadwick Farms* project. Upon cancellation of the LLC's certificate of formation, the LLC ceases to exist and can no longer sue or be sued. When cancellation occurs, any pending lawsuits by or against the LLC abate.<sup>3</sup>

### **Personal Liability of Individual LLC Members**

Although cancellation of an LLC will abate any claims against it, the Supreme Court cautions individual LLC members that they may be personally liable if they do not properly dissolve the LLC and provide for appropriate distribution of assets and payment of creditors. In that sense, the effectiveness of cancellation to eliminate claims depends on having followed all the rules in dissolution. It is not as simple as just filing a notice of cancellation or waiting for the Secretary of State to administratively cancel the LLC.

According to the Supreme Court, the following circumstances could result in making individual LLC members personally liable:

- (1) An individual LLC member may be personally liable if he or she is responsible for winding up the affairs of the LLC, and does so improperly, by failing to pay or make reasonable provision for paying all claims and obligations known to the company, including "contingent, conditional, or unmatured claims and obligations";

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<sup>3</sup> In the case of merger, however, the merged LLC's assets and liabilities continue in the resulting entity (or entities), though the LLC's separate legal existence ceases.

- (2) An individual LLC member is personally liable for his or her own torts;
- (3) An individual LLC member may be liable for contributions to which they have agreed and for the return of distributions made while the LLC is insolvent or would render the LLC insolvent if the member knew the distribution was wrongful;
- (4) An individual member may be liable under the theory of piercing the veil if respecting the LLC form would work injustice, in the same way an individual may be personally liable under the theory of piercing the corporate veil (factors include intentional use of the LLC form by members to violate or evade a duty to creditors, knowing participation by members, commingling assets between the LLC and members, disregard of corporate formalities by members and inadequate capitalization of the LLC).

To mitigate the risk of personal liability in the real estate development context, it is incumbent upon individual LLC members themselves to make sure the LLC procures reasonable insurance coverage throughout the applicable statute of limitation and statute of repose periods and to understand what is and what is not covered prior to the design and construction of a real estate development project. Further, LLC managers must ensure there are effective defense, indemnity and hold harmless provisions in contracts with contractors, subcontractors and design professionals. Towards the end of the project, it may be prudent to consider (a) maintaining the existence of the developer LLC to defend against HOA claims and pass through such claims to responsible contractors, subcontractors and design professionals or (b) preparing and executing a detailed winding up plan to make reasonable provision for any claims and obligations known to the company, including “contingent, conditional, or unmatured claims and obligations,” particularly if the LLC’s insurance policies do not cover such liabilities.

Members and managers of LLCs that sell property and discontinue operations after the sale of the real property should also consider employing personal liability mitigation efforts. Following the *Chadwick Farms* case, it is ill advised to dissolve an entity immediately upon a sale given the liabilities which arise under a purchase and sale agreement, such as representations and warranties as well as pre-existing liabilities, without making reasonable provisions for “contingent, conditional, or unmatured claims and obligations.”

### **Insurance Coverage Issues**

For years, liability insurers have been seeking a way to limit or eliminate their exposure under comprehensive/commercial general liability (“CGL”) policies issued to LLCs that have subsequently been dissolved – either before or during litigation. They may see the *Chadwick Farms* decision as a victory in such efforts. However, the insurers may not have done themselves much good, since, under most CGL policies issued to LLCs, the members and managers of an LLC are also covered insureds.

As a result of the *Chadwick Farms* decision, lawyers representing HOAs and other plaintiffs will almost certainly be more inclined to add claims against individual LLC members and managers in cases where the LLC has been dissolved or cancelled within six (6) years after project completion. In such cases it will be critical to be able to demonstrate that adequate provisions were made for resolution of future claims, including “contingent, conditional, or unmatured claims and obligations.” Liability insurance has traditionally been the means by which businesses have addressed such unknown future contingencies.<sup>4</sup>

***It is more important than ever to assure that your insurance coverage is as complete, comprehensive and up to date as possible, consistent with your economic capabilities and risk profile.*** The limited property damage coverage provided under many current CGL policies could potentially mean that individual LLC members may not have the protection of the liability insurance they assumed they paid for – leaving their personal assets exposed to claims based on the improper administration or winding up of an LLC.

### **Conclusion**

*Chadwick Farms* increases the likelihood that an individual member or manager of a discontinued LLC could be found personally liable for claims brought against the LLC after it is dissolved or canceled. As illustrated by the above case summary, there are many nuances and factual circumstances that will guide the LLC’s managers and members in dealing with contingent, conditional, or unmatured claims and obligations and how to properly dissolve, wind up and cancel an LLC or, alternatively, to properly continue the existence of the LLC. This briefing is not inclusive of all the recent cases or laws that you should be aware of when making your business decisions and you should not act on this information without seeking more specific professional advice. Further, the Washington Legislature will likely consider these issues in the next legislative session and enact new legislation which we will continue to monitor.

If we can help you with these or any related issues, we are happy to do so. Simply give your C&H attorney a call.

Very Truly Yours,

James P. Wagner  
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<sup>4</sup> Indeed, plaintiffs may take the position that an LLC’s failure to obtain adequate insurance coverage, *i.e.*, a policy that covers claims for water intrusion, multi-family projects, mold & fungus, etc., is in itself proof of a failure to make reasonable provision for payment of future loss contingencies.