Wrong Law Applied, Wrong Words Used, But the Correct Result Reached
***Stockdale v. Ellsworth*[1]**

By Herrick K. Lidstone, Jr., Burns, Figa & Will, P.C.

On December 18, 2017, the Colorado Supreme Court issued its opinion in *Stockdale v. Ellsworth*, 2017 CO 109. This opinion discussed some of my favorite subjects – piercing the veil of a limited liability entity (in this case, a limited liability company) and tracking down missing heirs of a successful oil and gas property. It also included some interesting civil procedure conclusions, as well.

Title Searches and Missing Heirs

Stockdale was based on production from oil properties in La Plata County, Colorado, owned of record by Roy P. Cardwell, deceased, who obtained record title to his mineral interest in 1938. Because Cardwell and his heirs could not be located in the 1990s when the Colorado Oil and Gas Conservation Commission authorized the pooling of interests in the area, the proceeds attributable to Cardwell's interest were held in suspense as the natural gas wells were developed. When XTO filed the interpleader action in 2009, the proceeds attributable to Cardwell's interest totaled approximately $2.7 million, and it was growing due to continuing production. That's real money in most people's opinion.

Chester J. Ellsworth had identified potential heirs of a Mr. Cardwell who died in California in 1971 (the "California heirs") and acquired a mineral deed from them based on representations that the properties in La Plata county were valueless because there was no oil and gas production and in fact there may be no minerals on the property. According to the Court, "Ellsworth also falsely warned the California heirs that they could be liable for any costs of production or accidents associated with their interests." Ellsworth made these misrepresentations to the California heirs even though (in the Court's words) "Ellsworth (or entities he controlled) had already received over $1 million in proceeds from mineral interests in adjoining lands."

In researching the interpleader action, XTO also identified heirs of a Roy P. Cardwell who died in Kansas in 1980 (the "Kansas heirs"), as well as two business entities managed by Ellsworth – CEMPCO, Inc. (a Colorado corporation formed in 1978) and Seawatch Royalty Partners, LLC (a Wyoming manager-managed LLC formed in 2009 and qualified to do business in Colorado). Before trial, the Kansas heirs and CEMPCO withdrew their claims, leaving the battle for rightful ownership between the California heirs and the grantee of the mineral deeds, Seawatch. Ellsworth, individually, was not a party to this action.

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After a seven-day bench trial, La Plata County Judge Dickinson issued his findings, order, and judgment on November 11, 2011. In the judgment, the trial court:

1. Granted the California heirs' claims for rescission of the mineral deeds and assignments, concluding that Ellsworth (on behalf of Seawatch) had obtained the deeds and assignments by fraud and misrepresentation.

2. Found that "Seawatch was at all material times an alter ego of Ellsworth" and therefore found Seawatch and Ellsworth "jointly and severally liable for attorney's fees incurred by XTO and the California heirs in responding to Seawatch's frivolous claims. The trial court referred to this as "piercing the corporate veil" even though Seawatch was a limited liability company. More on this below.

Seawatch appealed the judgment on various grounds. The Court of Appeals affirmed the trial court's judgment against Seawatch. The Colorado Supreme Court denied *certiorari.*

While the first appeal was pending, XTO and the California heirs filed motions seeking attorney's fees and costs from Seawatch and Ellsworth. They also filed a joint motion to join Ellsworth to the post-judgment proceedings pursuant to C.R.C.P. Rule 21 and *City of Aurora v. Colorado State Engineer*, 105 P.3d 595 (Colo. 2005). They were unable to serve Ellsworth (you can imagine him dodging service), and the trial court granted substituted service.

Ellsworth (acting *pro se*) made what he referred to as a "limited appearance" in the trial court in 2013 to argue several motions, including that the trial court lacked personal jurisdiction and the substitute service had been improper. In April 2014, Judge Herringer (replacing Judge Dickinson who had retired) denied those and other Ellsworth motions. In reaffirming the alter ego holding, the trial court articulated several additional findings relevant to whether "piercing the corporate [*sic*] veil was necessary to achieve an equitable result." The court found, for example, that:

a. Seawatch's sole business function was to acquire the mineral deeds from the California Heirs for Ellsworth's benefit, had no other business dealings, and was controlled entirely by Ellsworth;

b. Seawatch had no bank account and purchased the mineral deeds from the California heirs with personal checks from Ellsworth, and Ellsworth used personal checks or cash for other Seawatch expenses;

c. Seawatch was apparently insolvent and had no assets, such that limiting liability to Seawatch would foreclose any meaningful opportunity for injured parties to recover for conduct for which Ellsworth was responsible; and

d. There was no indication that Seawatch's litigation strategy was controlled by anyone other than Ellsworth.

The trial court concluded that "[t]he only respect in which Ellsworth has treated Seawatch as a corporate [*sic*] entity, independent of him personally, is as a barrier to liability. . . . To the extent that Seawatch advanced frivolous argument and made groundless claims, Ellsworth is the person who should ultimately be held responsible for that conduct." The trial court awarded fees and costs to XTO and the California heirs in May 2015. Ellsworth appealed *pro se* against his personal liability inasmuch as he alleged that he was not a proper party to the case. The Court of Appeals agreed with Ellsworth and vacated that part of the trial court's judgment.

Ah, then the greed really kicks in. Ellsworth, having just been exonerated from personal liability by the Court of Appeals, files a petition for a writ of *certiorari* with the Colorado Supreme Court seeking "relief of manifest injustice to include $200,000,000 in exemplary damages pursuant to § 13-17-101 to punish the trial court's and Respondent's acts of frivolous, groundless and vexatious litigation." Talk about hubris. After some further filings by Ellsworth, the Supreme Court denied Ellsworth's petition for *certiorari* but granted the cross-petition filed by the California heirs to review the Court of Appeals' ruling on whether Ellsworth had been properly joined in the case – leading to his liability on the alter ego theory.

Piercing the Veil and Colorado's Internal Affairs Doctrine

The principal case is long over, but the history and the course of the litigation is fascinating. I have written several times about judicial decisions dealing with piercing the entity veil – not always in a favorable manner. See my discussions of *Weinstein v. Colborne Foodbotics, LLC*, 302 P.3d 263 (Colo. 2013) (which I discussed in the June 2013 Business Law Section Newsletter), *Martin v. Freeman*, 272 P.3d 1182 (Colo. App. 2012) (which I discussed in February 2012), *McCallum Family LLC v. Winger*, 221 P.3d 69 (Colo. App. 2009) (which I discussed in December 2009), and *Sheffield Services Co. v. Trowbridge*, 211 P.3d 714 (Colo. App. 2009) (discussed in November 2009). I have also seen too many litigators discuss piercing the entity veil of a limited liability company without recognizing that, as the Colorado Supreme Court recognized in *Weinstein* (in connection with potential liability under C.R.S. § 7-80-606(2)), an LLC is not a corporation.

The Internal Affairs Doctrine – Application of Wyoming Law Should Have Been Considered. Seawatch is a Wyoming LLC. Colorado, like most other states, has adopted the "internal affairs" doctrine by which "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. Even then, I think that the Colorado courts would have imposed liability on Ellsworth, but the fact remains that the Colorado courts did not even consider the applicability of Wyoming law.

An LLC Is Not A Corporation And Does Not Have A Corporate Veil. Even assuming that Colorado law (as applied by the courts and apparently argued by the Colorado litigators) was applicable, another failure was that the Supreme Court uses the phrase "corporate veil" 21 times.

Only three times is the term used in reference to a corporation. The opinion refers to "corporate veil piercing" with respect to Seawatch, a limited liability company and not a corporation, at least eight times, including those mentioned above. The fact remains that a limited liability company does not have a "corporate veil" even though it is intended to provide liability protection to its members except as described in C.R.S. § 7-80-107 (again, assuming that Colorado law was applicable):

> (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.
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> (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.

The Colorado Limited Liability Company Act requires the court to apply common law applicable to piercing the veil of corporations – but it does not say that the veil protecting the owners of an LLC is a "corporate veil." It is not, and courts and the litigators presenting cases to the courts should not mischaracterize the nature of the LLC – it is an unincorporated entity.

(i) The Supreme Court's opinion uses other language inappropriately when it cites the trial court in stating: "Specifically, the trial court found that Ellsworth was the sole managing partner of Seawatch, which he owned with his wife and two adult children." Please – an LLC does not have a managing partner or any partner at all. The owners are "members" and in this case of a manager-managed LLC, the manager is a manager.

(ii) The Court's opinion also refers to Ellsworth as Seawatch's "managing member" in several places. Under Wyoming law Seawatch was a manager-managed LLC and the articles of organization filed with the Wyoming Secretary of State named Ellsworth as the manager – not a "managing member."

Words are important, and the courts in Colorado and the litigators who present cases to the courts should use the words correctly. The jurisdiction of organization of the entity is equally important, and litigators should argue, and courts should apply, the "internal affairs" doctrine properly. [The internal affairs doctrine was not discussed, and the Delaware organization of the LLC in question was ignored, in *Martin v. Freeman* as I discussed in an earlier newsletter.]

A failure to consider the correct law and to use the correct terminology can only confuse transactional lawyers and litigators looking at these cases for precedent.

In this case, however and notwithstanding the inappropriate use of words and the failure to consider the applicability of Wyoming law, the entity veil of Seawatch was in my opinion properly pierced based on the findings of fact made by the trial court and restated by the Supreme Court. The facts cited above confirm the conclusion of the trial court and recited by the Supreme Court that "[t]he only respect in which Ellsworth has treated Seawatch as a corporate [*sic*] entity, independent of him personally, is as a barrier to liability." Seawatch had no bank account or separate accounting, and it was clear from the facts as determined by the trial court that Ellsworth used Seawatch to operate a fraud on the California heirs and XTO.

Was Ellsworth Properly A Party?

Of course, if the trial court did not have jurisdiction over Ellsworth, he never would have been liable for damages as a result of the court's piercing the entity veil. For that reason, he should have stopped at the Court of Appeals decision reversing the trial court and accepting his argument that he did not have personal liability because of a lack of jurisdiction. Whether the California heirs would have appealed that decision is unknown; perhaps they were just relieved that the matter was over. Ellsworth's efforts to seek a $200,000,000 vindication on a *pro se* basis backfired on him.

In its opinion, the Supreme Court acknowledged "that a person is not bound by a judgment if he was not 'designated as a party or . . . made a party by service of process," *citing Zenith Radio Corp. v. Hazeltine Research, Inc.*, 395 U.S. 100, 110 (1969). Considering the facts, however, the Court concluded "that Ellsworth was a party to the post-judgment proceedings" based on the Court's interpretation of the *City of Aurora* case. In *City of Aurora*, after the trial court entered its order of dismissal following an eight-week trial, the prevailing party sought attorneys' fees and costs under C.R.S. §13-17-102(4). The prevailing party moved to join Aurora solely "for purposes of collecting attorney fees and costs." The court granted joinder, and the Supreme Court affirmed. The Court explained the *City of Aurora* decision as follows [*citations omitted]*:

> Parties may be dropped or added by order of the court on motion of any party . . . at any stage of the action and on such terms as are just." . . . (quoting C.R.C.P. 21). Rules 20 and 21, which should be "liberally construed," specifically "authorize joinder in situations where one party seeks to join a person who may be liable for the same debt or conduct that is already before the court." . . . These rules "indicate clearly a general policy to disregard narrow technicalities and to bring about the final determination of justiciable controversies without undue delay." . . . Thus, we held, joinder of Aurora was not an abuse of discretion, even though the court had already entered judgment on the merits, "[b]ecause C.R.C.P. 20 allows joinder at any stage of the proceedings and because C.R.C.P. 21 anticipates joinder where there are joint liabilities, as well as common questions of law and fact," and Aurora "was potentially liable for conduct that was already before the court."

The Supreme Court concluded "that Ellsworth, who was properly joined to the post-judgment proceedings, had notice and opportunity to contest his individual liability."

Conclusion

Stockdale v. Ellsworth is an interesting case from several angles, factual, legal and procedural. It was properly decided under Colorado law and, I suggest, even under Wyoming law had the Colorado courts properly considered the Colorado internal affairs doctrine. We can only ask that, when applying entity legal principles, the courts, and the attorneys practicing before the courts, choose their words, and applicable law, more carefully. Doing so will avoid confusion and problems for practitioners and their clients.