

Dissolving A Corporate Contractor: Using A Liquidating Trust To Limit Personal Liability

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This paper explains the use of a liquidating trust to limit the personal liability of directors and shareholders when a construction corporation is dissolved. The recent downturn of the economy, and the construction industry in particular, has resulted in the closure of many construction firms. This paper addresses the required steps to formally dissolve a construction corporation. The paper then explains how a liquidating trust can be used to limit the personal liability of the directors and shareholders at the dissolution of the corporation.

Key Words: Corporation, Directors, Shareholders, Liquidating Trust, Legal Liabilities

Introduction

The potential legal liabilities of a contractor are many and substantial. Contractors face not only general business risks (which have increased due to the downturn in the economy and in the construction industry in particular) but also unique legal risks related to improper construction, personal injuries (including worker claims), and construction defect litigation. To limit the personal liability of the owners of a construction business, a separate legal entity is often created to hold the construction license and act as the licensed contractor. In California, where the author practices, the historical entity of choice to achieve limited liability is the corporation. Although the limited liability company ("LLC") is available in California for most businesses, the 2010 legislation authorizing contractor licenses for LLCs has not (as of this writing) been implemented by the California Contractors State License Board (the "CSLB") and no LLC license has yet been issued by the CSLB. In addition, because of additional requirements on an LLC, not required for a corporation, it is yet to be seen how many applicants would choose an LLC in place of a corporation.

In perhaps no other state have the legal risks to contractors increased, over the last ten years, as much as in California, where the Legislature has enacted numerous measures to limit and control construction defect litigation. As the risks have increased, and the volume and profitability of the business have decreased, many contractors have "closed the doors". For a sole proprietorship, closure does not require significant legal documentation. However, for a corporation (which is a "creature of statute" and is created and operates pursuant to statute), the requirements for closure are dictated by statute (all references in this paper are to California statutes; the statutory rules vary from state to state). These requirements are generally referred to as the process of "dissolution" (the formal decision and paperwork to dissolve the corporation), "winding-up" (the period during which the corporation's assets are marshaled and sold and its liabilities are paid or otherwise provided for), and "distribution" (when the remaining assets, if any, of the corporation are distributed to the shareholders).

This paper presents the general requirements for a corporate dissolution. The paper then sets forth the rules which require that the debts and liabilities of a corporation be addressed at dissolution. The paper then describes the statutes of limitation which apply to claims related to (1) the dissolution process and (2) construction defect litigation. The paper then explains how the risks of personal liability, to the directors and shareholders, in connection with a corporate dissolution can be reduced through the use of a liquidating trust.

The Dissolution Process

Most of the rules related to corporations (including creation, operation, and dissolution, winding-up, and distribution) are set forth in the California Corporations Code (hereinafter the “Code”), as are the rules for other legal entities, including LLCs (the rules which apply to the legal entities are generally similar from state to state; however one must be careful to follow the specific rules of the state in which the entity was created). The rules pertaining to dissolution are found at Sections 1900, et seq. of the Code. These rules generally (there are exceptions) require, for a voluntary dissolution, the following:

1. Shareholders holding shares representing 50 percent or more of the voting power of the shareholders must vote to wind up and dissolve the corporation (Section 1900),
2. A certificate of election to wind up and dissolve is signed by the requisite number of directors or shareholders (Section 1901), and
3. A certificate of dissolution (the “Certificate”) – on a form required by the office of the California Secretary of State (the “Secretary”) – is filed with the Secretary by which a majority of the board of directors must verify, as to the corporation, among other things, “(2) That its known debts and liabilities have been actually paid or adequately provided for, or paid or adequately provided for as far as its assets permitted, or that it has incurred no known debts or liabilities, as the case may be. . .” (Section 1905(a)(2)).

The existence of the corporation ceases upon the filing of the Certificate, except for the purpose of further winding up if needed (Section 1905(b)) and except as otherwise provided by statute. For example, Section 2010 provides in relevant part:

(a) A corporation which is dissolved nevertheless continues to exist for the purpose of winding up its affairs, prosecuting and defending actions by or against it and enabling it to collect and discharge obligations, dispose of and convey its property and collect and divide its assets, but not for the purpose of continuing business except so far as necessary for the winding up thereof.

Debts And Liabilities

The board of directors of a corporation is obligated by statute, as part of the process of dissolution, to pay or adequately provide for all known debts and liabilities. This obligation is imposed by Section 2004 which reads:

After determining that all known debts and liabilities of a corporation in the process of winding up have been paid or adequately provided for, the board shall distribute all the remaining corporate assets among the shareholders according to their respective rights and preferences. . . (emphasis added).

The failure to pay or adequately provide for known debts and liabilities results in the personal liability of the members of the board of directors under Section 316, which, in relevant part, provides:

(a) Subject to the provisions of Section 309, directors of a corporation who approve any of the following corporate actions shall be jointly and severally liable to the corporation for the benefit of all of the creditors or shareholders. . . (2) The distribution of assets to shareholders after institution of dissolution proceedings of the corporation, without paying or adequately providing for all known liabilities of the corporation. . . .

The reference to Section 309 is to the basic statement of the “business judgment rule” which applies to the decisions and actions of the board of directors. Section 309 (a), in relevant part, provides:

(a) A director shall perform the duties of a director,. . . , in a manner such director believes to be in the best interests of the corporation and its shareholders and with such care, including reasonable inquiry, as an ordinarily prudent person in a like position would use under similar circumstances. Section 309(b) authorizes a director, in making decisions, to rely upon various persons and Section 309(c), very importantly, provides protection to a director who satisfies Section 309 (a) and (b) by providing:

(c) A person who performs the duties of a director in accordance with subdivisions (a) and (b) shall have no liability based upon any alleged failure to discharge the person’s obligations as a director.

Separate and apart from the liability of directors, the shareholders of the corporation may have personal liability if distributions are made and the corporation’s liabilities are not properly addressed. Section 2009(a) provides:

Whenever in the process of winding up a corporation any distribution of assets has been made, otherwise than under an order of court, without prior payment or adequate provision for payment of any of the debts and liabilities of the corporation, any amount so improperly distributed to any shareholder may be recovered by the corporation. Any of such shareholders may be joined as defendants in the same action or brought in on the motion of any other defendant.

Third persons (i.e., creditors of the corporation) are authorized by Section 2011(a)(1) to pursue direct claims against the shareholders if distributions of corporate assets have been made to shareholders and the corporation’s liabilities have not been properly paid or provided for.

As this discussion makes clear, it is critical to the corporation, and to its directors and its shareholders, that the debts and liabilities of the corporation are properly addressed during the dissolution process. This task is difficult enough as to “liquidated” debts (known debts for which the amount of the debt is also known). The task is far more complicated when a claim, or potential liability, is known, but the ultimate outcome of the claim (for example, a lawsuit alleging defective construction) is unknown. And even more difficult yet to evaluate is the possibility of a claim/liability which may – due to the long statutes of limitation which exist – be unknown at the time of dissolution and which may be first asserted many years after dissolution.

Statutes of Limitation

A statute of limitation is a rule which requires that a lawsuit be initiated within a specific period of time, which usually begins to run at the occurrence of the event which is the basis of the lawsuit. In California, and in many other states, these statutes of limitations are found in statutes (laws passed by the state’s legislative branch). In California, the general statutes of limitation are found in the California Code of Civil Procedure (“CCP”); other specific statutes of limitation are found in other statutes.

General Statutes

The generally applicable statutes of limitation, which would apply to contractors, as well as to other businesses, are:

- Breach of an oral contract – two years (CCP Section 339(1)).
- Breach of a written contract – four years (CCP Section 337).
- Personal injury – two years (CCP Section 335.1).
- Property damage – three years (CCP 338).

(Note: these general rules are subject to many “exceptions”, which may further extend the time period during which the lawsuit may be commenced).

Construction Defect Statutes

In addition to the general statutes of limitation, California has adopted two specific rules which apply to contractors (and others) related to deficiencies in “. . . design, specifications, surveying, planning, supervision or observation of construction or construction of an improvement to real property. . .” CCP 337.1 and CCP 337.15. With a number of exceptions, CCP 337.1 requires that an action must be filed within four years after substantial completion for any “patent deficiency”, which is defined in CCP 337.1(e) as “. . . a deficiency which is apparent by reasonable inspection”. CCP 337.15, again with numerous exceptions, requires that an action must be commenced within ten years after substantial completion for any “latent deficiency”, which is defined in 337.15(b) as “. . . a deficiency which is not apparent by reasonable inspection”. What constitutes “substantial completion” is trade specific and is generally the first to occur of the date of (1) final inspection by the applicable public agency, (2) recordation of a valid notice of completion, or (3) use or occupation of the improvement CCP 337.15(g). It is this ten year statute of limitations for latent defects which is of particular concern to contractors because, theoretically and practically, a contractor cannot “close its books” on a construction project until ten years after substantial completion.

Corporate Dissolution Statutes

In connection with the dissolution of a corporation, the statutes of limitations are (with exceptions) as follows:

- Violation by a director of the “business judgment rule” of Section 309 - four years (CCP Section 343).
- Action against a director for making improper distributions to shareholders under Section 316 – four years (CCP Section 343).
- Action by a third party against a shareholder for receipt of improper distributions under Section 2011 – the earlier to occur of: “(A) The expiration of the statute of limitations applicable to the cause of action” (for example, the ten year statute for latent defects in construction) or “(B) Four years after the effective date of the dissolution of the corporation” Section 2011(a)(2). The effective date of the dissolution is the date that the Certificate is filed by the Secretary.

It is this four year statute of limitations of Section 2011, which applies to actions against shareholders, that provides, together with the four year statute of limitations applicable to the personal liability of directors, the opportunity to reduce the liabilities of directors and shareholders at the time of dissolution.

Using A Liquidating Trust At Dissolution To Reduce Liabilities

Should a corporate contractor which decides to “close its doors” dissolve the corporation? If the corporation is dissolved, how should the corporation “pay or adequately provide for” its known debts and liabilities. In light of the above discussed rules, and although there may be reasons in specific cases not to dissolve the corporation (such as substantial pending litigation in which the corporation’s liability may exceed its insurance limits and/or assets), it is suggested that dissolution of the corporation through use of a liquidating trust is, of the various options available, the preferred course of action.

One alternative is to leave the corporation in place to protect the shareholders from personal liability. This option might be the option of choice if there are substantial known claims and/or liabilities (for example, claims involving toxic materials and/or hazardous substances) with substantial potential exposure. The primary “disadvantage” to this option is that the ten year statute of limitations applicable to latent defects will not be shortened. Further, maintaining the existence of the corporation may require annual fees (in California, a corporation must pay an

annual fee of \$800) and expenses of tax returns and other filings. Additionally, if the corporation is maintained for ten years, after substantial completion of its last construction project, and then dissolved, the shareholders may still be liable under Section 2011(a)(2) for an additional four years.

It is, therefore, often advantageous to dissolve the corporation as quickly as is feasible – to “start the clock” on the personal liability of the directors (under the four year statute of limitations found in CCP Section 343) and the shareholders (under the four year statute of limitations found in Section 2011(a)(2)) if the board of directors can develop a plan to insure that “. . . all of the known debts and liabilities of a corporation in the process of winding up have been paid or adequately provided for. . .” Section 2004 (emphasis added). It is as to this statutory requirement of Section 2004 that the liquidating trust has significant advantages over the other options available to deal with “known debts and liabilities”.

One option is to pay – in full – all of the known debts. While this might be possible as to some debts, this would preclude contesting the debt/claim. Further, claims are often made, in litigation against contractors, for large amounts of money in cases which ultimately result in no, or minimal, liability to the contractor. Finally, it is often not determined, until the lawsuit is resolved (or in some cases years later) whether all or part of the liability of the contractor is covered by insurance. For these reasons, it is usually not feasible or advantageous for the board of directors to pay “all known debts and liabilities”.

A second option is to distribute the assets of the corporation in connection with a promise by the shareholders to personally assume all known debts and liabilities. This plan has obvious and terminal disadvantages. Most importantly, the shareholders who have – for years – avoided personal liability are now expressly liable and will be sued personally. Even if the liability is not joint and several (i.e., is shareholder “A” liable for distributions to shareholder “B” if “B” is insolvent), issues arise as to (1) the tracing of distributions into other investments and (2) the liability at the death of the shareholder or heirs (i.e., spouse and children) and beneficiaries. For these reasons, this option is not advisable.

What is needed, then, is an option which (1) allows the corporation to be dissolved, in order to “start the clock” on the four year statutes of limitations in CCP Section 343 and Section 2011(a)(2), and (2) provides an entity other than the corporation to “adequately provide for” the known debts and liabilities of the corporation. The liquidating trust provides this entity.

A liquidating trust is a trust, created by a written “Trust Agreement” by which the corporation (as the “Trustor”) agrees to transfer specific assets of the corporation to the trust, which is managed by one or more individuals (as the “Trustee”) who agree to hold and utilize the assets of the trust for the express purpose of the payment of the known debts and liabilities of the corporation. Neither the type of assets which can be placed in the trust or the value of the assets is addressed by statute. It is the author’s practice, when dissolving a corporation using a liquidating trust, to have the board of directors – as part of its plan of dissolution and winding up – prepare a detailed schedule of every known debt or liability (the board of directors is not required to address claims which are not known at the time of dissolution) and then determine, with a view toward the protection provided by the “business judgment rule” (Section 309), the amount of assets which is sufficient to “adequately provide for” each known debt/liability. The author suggests that all known debts be listed and evaluated, even those which are covered by insurance, because insured claims may be subject to deductibles and/or limitations in defense costs and/or coverage. Once the “reserve” amount is determined for each liability, the total “reserve” can be determined. It is then the author’s practice (sometimes opposed by clients) to increase the value of the reserved assets by a factor of 25-35 percent over the calculated reserve, it being the author’s opinion that the board of directors, if questioned in the future as to the manner in which the reserve was calculated, can rely upon this conservative formula to avoid director and shareholder personal liability.

Attached as Appendix “A” is the template of a Trust Agreement (the “Agreement”) used by the author to create a liquidating trust. “Recitals” “A” through “F” of the Agreement establish the purpose of the trust and reference the Exhibits to the Agreement, which are as follows:

- Exhibit “A”: List of shareholders.
- Exhibit “B”: Plan of complete liquidation and dissolution.

- Exhibit “C”: List of known contingent liabilities.
- Exhibit “D”: List of corporate assets to be transferred to the trust.

The balance of the Agreement (paragraphs 1 through 14) provides for the operation of the trust by the Trustees.

The assets of the corporation which are not allocated to the liquidating trust can, pursuant to the plan of dissolution, be distributed to the shareholders on a pro rata (according to the number of shares held by each) basis. The assets allocated to the liquidating trust are formally transferred to the trust, which will obtain a separate taxpayer identification number. Depending on the type and value of assets contributed to the trust, it may be necessary for the trust to file income tax returns. The trust can, to avoid income tax at the trust level, provide for distributions of “net income” to the shareholders. During the term of the trust, which is designed to exist for a minimum of four years after the filing of the Certificate, the Trustees have the power to (1) manage/invest the trust assets and (2) use the trust assets to pay the specified debts/liabilities of the corporation. If all of the known debts/liabilities are resolved by the end of this four year period, at the end of the period the remaining assets are distributed pro rata to the shareholders. In the event the known debts/liabilities are not resolved within this four year period (which unfortunately is not uncommon in California due to prolonged construction defect litigation), one could argue that the remaining assets could nevertheless be distributed to shareholders. However, it is the author’s practice to advise that the assets be maintained in the liquidating trust (usually at low or no cost) until all known debts/liabilities have been finally resolved. The remaining assets can then be distributed to shareholders.

Conclusion

Corporations are commonly used, as the form of entity for contractors, to limit the personal liability of the owners/shareholders for the debts and liabilities of the corporation. When a corporate contractor ceases to do business, the formal dissolution of the corporation can shorten the statutes of limitation which may otherwise apply to the corporation. Upon dissolution, care must be taken to not expose the directors and shareholders of the corporation to the debts and liabilities of the entity. A liquidating trust can be created, as part of the dissolution process, to insure that the company debts and liabilities have been “adequately provided for”. The liquidating trust is used in this manner to limit the personal liability of the directors and shareholders.

References

California Code of Civil Procedure, Section 335.1

California Code of Civil Procedure, Section 337

California Code of Civil Procedure, Section 337.1

California Code of Civil Procedure, Section 337.15

California Code of Civil Procedure, Section 338

California Code of Civil Procedure, Section 339 (1)

California Code of Civil Procedure, Section 343

California Corporations Code, Section 309

California Corporations Code, Section 316

California Corporations Code, Section 1900

California Corporations Code, Section 1901

California Corporations Code, Section 1905

California Corporations Code, Section 2009 (a)

California Corporations Code, Section 2010

California Corporations Code, Section 2011

Appendix A

Trust Agreement

This Trust Agreement (the "Agreement") is entered into by and between _____ (the "Corporation"), a California corporation in the process of dissolution, and _____ (the "Trustees"), and is made with reference to the following agreed facts:

Recitals:

1. Corporation has shares of outstanding stock owned by the shareholders in the amounts set forth on the list of shareholders attached hereto as Exhibit "A" and herein incorporated by reference (such shareholders on the shareholder list are herein referred to as "Beneficiary" or "Beneficiaries"),
2. Effective _____, shareholders owning one hundred percent (100%) of the Corporation's outstanding voting stock elected in writing to wind up and dissolve the Corporation, authorized its directors to adopt a plan of liquidation, and authorized and directed its officers to take such action as may be necessary or proper to wind up the affairs of the Corporation and dissolve it,
3. Under the authority identified in paragraph 2., above, the Corporation's directors adopted, effective _____, a Plan Of Complete Liquidation And Dissolution (the "Plan"), a copy of which is attached hereto as Exhibit "B" and is herein incorporated by reference,
4. The Plan contemplates the creation of a liquidating trust to provide for payment of the Corporation's known contingent liabilities pursuant to the provisions of California Corporations Code Section 2004,
5. The directors of Corporation have identified all of Corporation's known contingent liabilities, and such liabilities (the "Liabilities" or the "Liability") are set forth in Exhibit "C" attached hereto and herein incorporated by reference, and
6. Corporation and Trustees wish to enter into an agreement which provides for the distribution by Corporation to Trustees of the assets of Corporation which are identified in Exhibit "D" attached hereto and herein incorporated by reference (the "Assets") for the purpose of having Trustees receive such Assets for and on behalf of the Beneficiaries in complete liquidation of the Corporation after paying any and all debts and liabilities to which such Assets are subject and for the purpose of distributing any of such Assets which remain on termination of the trust to Beneficiaries.

NOW, THEREFORE, Corporation and Trustees hereby agree as follows:

1. Corporation hereby transfers and assigns to Trustees the Assets, in trust, to be held, administered and distributed as hereinafter provided. Subject to the terms and conditions of this Agreement, the Trustees shall have all of the rights of an owner of the Assets and may exercise the rights and privileges of an owner with respect to such Assets. Corporation shall execute and deliver to Trustees all documents necessary to transfer such Assets to Trustees. The Corporation may, from time to time, transfer additional assets to the Trustees.
2. The Trustees shall hold and administer the trust estate, including (1) the Assets, (2) any additional assets transferred to the Trustees by Corporation, (3) income from the Assets and, (4) if applicable, any income from additional assets transferred to the Trustees by Corporation, for the purpose of having available sufficient assets in the trust estate to pay the Liabilities. The Trustees shall pay, from the trust estate, such of the Liabilities as are determined by a final judgment of a court of competent jurisdiction to be owned by Corporation.
3. Trustees shall have the authority, in Trustees' discretion to pay, without any legal action against Corporation, any of the Liabilities and/or to settle or compromise any of such Liabilities.
4. The Trustees are authorized, in the Trustees' discretion, to defend against any claim with respect to any of the Liabilities and to pay, from the trust estate, all of the expenses of resisting such claims, including, but not limited to, attorney's fees.
5. The Trustees shall, from time to time, as determined by the Trustees, in the Trustees' discretion, distribute to the Beneficiaries, in proportion to their respective stock ownership interest in Corporation, such portion of the trust estate, including principal and/or income, as the Trustees determine, in the Trustee's discretion, is not necessary to provide for payment of the Liabilities.
6. The Trustees may, in the Trustees' discretion, pay debts and/or liabilities of Corporation, other than the liabilities, if the Trustees determine that (1) such debt or liability is one for which the Beneficiaries would be legally responsible as a result of the dissolution of Corporation, and (2) such debt or liability is not barred by the applicable statute of limitations specified in California Corporations Code Section 2011(a)(2). Nothing in this paragraph 6 shall be interpreted to: (a) require the Trustees to pay any debt or liability of Corporation other than the Liabilities, or (b) limit the Trustees' discretion, as provided in paragraph 5, above, to distribute principal and/or income of the trust estate to Beneficiaries, or (c) delay the termination of the trust as provided in paragraph 13, below.
7. Under no circumstances shall the Trustees conduct any business of any nature on behalf of the trust estate. The trustees' activities shall be limited to the collection, investment, disposition and distribution of the trust estate as set forth in this Agreement.
8. Subject to the provisions of paragraph 7, above, the Trustees shall have all of the powers specified in California Probate Code Sections 16200-16249, inclusive.
9. The Trustees shall: (a) prepare and file all federal and state tax returns required to be filed by the trust, (b) keep and maintain adequate books and records of the Trustees' transactions as trustee and furnish annually to the Beneficiaries a statement showing the trust's remaining assets, gross receipts, and gross disbursements other than distributions to Beneficiaries, and (c) upon termination of the trust, prepare and make available to Beneficiaries a complete account of all of Trustees' transactions as trustee under this Agreement.
10. All expenses of the Trustees in carrying out the purposes of this trust shall be paid from the trust estate. Such expenses shall include, without limitation, the Trustees' fee for acting as trustee, real or personal

property taxes on the trust estate, attorneys' or accountants' fees, or both, and the expense of collecting or selling any assets of the trust estate.

11. The Trustees shall be paid a reasonable fee for the Trustees' services in administering this trust.
12. The initial Trustees of the trust shall be _____ and _____ and any and all actions of the Trustees shall require approval of _____ (____) of these _____ (____) Trustees; upon the death, resignation, or inability of any of _____ or _____, to serve as a trustee, the remaining _____ (____) Trustees shall continue to serve and any and all actions of the Trustees shall require approval of _____ Trustees.
13. This trust is irrevocable and shall terminate as provided in this paragraph 13.
 - (a) The trust shall terminate four (4) years after the effective date of the dissolution of the Corporation (i.e. – the filing of the Certificate Of Dissolution – the "Effective Date") if by such date (the "Termination Date"), all of the Liabilities have been discharged by payment or compromised settlement.
 - (b) The Trust shall terminate on the Termination Date if by such Termination Date, there are no Liabilities which have not been paid, or compromised, and, if there are any Liabilities which have not been paid, or compromised, no legal action against Corporation or Beneficiaries has been filed with respect to such Liability.
 - (c) If, by the Termination Date, any of the Liabilities has not been paid or settled by compromise, and if legal action with respect to any such unpaid or unsettled Liability has been filed so as to avoid the expiration of the applicable statute of limitations specified in California Corporations Code Section 2011(a)(2), this trust shall terminate when there are no Liabilities which have not been finally resolved by either (1) payment (in full or by compromise settlement), or by (2) the expiration of the applicable statute of limitations specified in California Corporations Code Section 2011(a)(2), or by (3) termination of any legal proceedings with respect to such Liability.

Corporation and Trustees expressly declare that it is their intention that this trust shall terminate when the purpose of the trust has been accomplished, which purpose is to provide a means of payment of the Liabilities, and that such purpose will have been accomplished when all of such Liabilities have either been paid, settled by compromise, barred by the applicable statute of limitations, or resolved by litigation commenced prior to the expiration of the applicable statute of limitations.
14. Upon termination of this trust, as provided in paragraph 13, above, the Trustees shall distribute the entire trust estate to the Beneficiaries in proportion to their respective stock ownership interest in Corporation.

Dated: _____

_____, INC.,
a California corporation

By: _____
Its President

By: _____
Its Secretary

Dated: _____

_____, INC.,
LIQUIDATING TRUST

By: _____
Trustee

By: _____
Trustee