A Chink in the Armor: Limited Liability Business Entities Do Not 'Absolutely' Protect Owners From Personal Liability

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Limited liability protection offered by business entities is invaluable to owners. However, that protection is not absolute. In certain circumstances, an owner may be held personally liable for wrongful actions, even when those actions are done in furtherance of the entity's business.

Business owners are correctly advised that they risk significant personal liability by failing to conduct business through a business entity such as a corporation or limited liability company ("Limited Liability Entity"). That advice has been heeded. As a result, the use of Limited Liability Entities, particularly limited liability companies, has never been more commonplace. Many owners form a Limited Liability Entity for each new project or venture, eventually accumulating a portfolio of Limited Liability Entities that would make Warren Buffett blush.

However, amidst this prolific use of Limited Liability Entities, there is a misconception that the use of one will protect an owner from all personal liability relating to an Entity's business — that the owner can rest easy in the knowledge that the Limited Liability Entity is a personal suit of armor. While Limited Liability Entities remain invaluable, there is a chink in the armor. The North Carolina Court of Appeals recently made it clear in the January 2011 decision of White v. Collins Building, Inc. ("White"), that use of a Limited Liability Entity does not always protect its owner from personal liability for the owner's own wrongful actions (or "torts") even when those actions are taken in furtherance of the Limited Liability Entity's business. This article will discuss the White decision* and the meaning of that decision for owners of Limited Liability Entities.

The White Decision

In 2003, the Whites purchased an ocean-front home on the North Carolina coast from a developer. The home had been built for the developer by Collins Building, Inc., a business owned by Edwin Collins ("Mr. Collins"). During construction, Mr. Collins personally supervised the work of various subcontractors.

In October of 2006, the Whites began to notice a slight buckling of the floors around certain windows and doors as well as water intrusion around certain windows. In response, the Whites contacted Mr. Collins who inspected the suspect areas, arranged for caulk to be added to the doors, and advised the Whites to clean sand out of their window sills to ensure a tight seal.

By late 2008, the Whites noticed more significant damage to the floors, as well as rusting and other signs of water damage around the windows. In April 2009, a professional inspection revealed significant water damage which required replacement of the windows. Additionally, between July 2007 and February 2009, four different water pipes burst in the home, causing damage to several walls and a ceiling. A professional inspection revealed that all of the hot water lines in the home had to be replaced.

In May 2009, the Whites filed a lawsuit against, among others, Collins Building, Inc. and Mr. Collins, individually. In response
to the lawsuit, Mr. Collins argued that he could not be held personally liable for any damage to the home since he acted, at all times, in his official capacity as owner of Collins Building, Inc. He argued that if he acted negligently, Collins Building, Inc. might be liable, but he is not. The trial court agreed and entered an order dismissing the Whites’ claims against Mr. Collins personally. The Whites appealed to the North Carolina Court of Appeals.

In January 2011, the Court of Appeals reversed the trial court’s order and held that the Whites could continue with their claims against Mr. Collins and could recover from him personally if they proved that he acted negligently. In its decision, the Court of Appeals made clear that an individual business owner can be held personally liable for the owner's own wrongful conduct. The Court stated: "It is well settled that an individual [owner of a Limited Liability Entity] may be individually liable for his or her own [wrongful acts], including negligence…notwithstanding that he may have acted as officer for a [Limited Liability Entity]."

Collins had personally supervised construction of the home and advised the Whites with respect to their windows and doors. That personal involvement was sufficient to allow the Whites to look behind Mr. Collins' Limited Liability Entity and expose Mr. Collins to personal liability if his actions caused damage to the Whites.

**What Does the White Decision Mean for Business Owners?**

The *White* decision applies to any situation where a business owner personally commits, or participates in, actions that are negligent or otherwise wrongful and that cause damage to other persons or property. Under *White*, if the business owner actively participates in the wrongful act, the owner may become personally liable. Importantly, the person or entity harmed by the owner's wrongful actions has the choice to attempt to recover from the business owner personally, the Limited Liability Entity itself because the wrongful act was done on behalf of the Limited Liability Entity, or both. Although the Limited Liability Entity and the business owner both may be liable for a wrongful act, the party harmed by the act may not recover twice.

*White* does not lessen the importance of forming a Limited Liability Entity. Although the *White* decision reveals an unavoidable potential for personal liability when business owners actively participate in their Limited Liability Entities, nothing in the *White* decision, and nothing in this article, should be construed to reduce the importance of forming a Limited Liability Entity.

The *White* decision does not change the important principle that a business owner generally is not personally liable for debts incurred by the Limited Liability Entity or for the performance of the Entity’s obligations (unless those debts or obligations are personally guaranteed or, as in *White*, personally performed by the owner). Nor does the *White* decision change the potential tax and other advantages available as a result of the formation and use of a Limited Liability Entity.

**Insurance implications.** Although business owners may have procured policies of insurance in the name of their Limited Liability Entities, they should not assume that those corporate policies provide coverage for the owner's personal liability. Instead, owners should consult with their insurance agents to discuss the scope of coverage under existing corporate policies and to determine whether products exist which may insure the owners from the risk of personal liability for their own wrongful conduct.

**The legal concept discussed in White is not a new one.** The fact that an individual acting on behalf of a business entity may be personally liable for the individual’s own wrongful conduct is not a new legal concept. The following hypothetical illustrates a common example of this concept:

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Truck Driver works for Big Truck Trucking, LLC. While driving the company’s big truck on company business, Truck Driver negligently collides with Victim’s vehicle, seriously injuring Victim. Truck Driver is personally liable to Victim for Victim’s injuries. Big Truck Trucking, LLC may also be liable.
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In the above hypothetical, Truck Driver is personally liable to Victim because the injuries resulted from Truck Driver’s own wrongful conduct, despite the fact that Truck Driver was carrying out official duties as an employee of Big Truck Trucking, LLC. *White* simply points out that if Truck Driver was, in fact, the owner of Big Truck Trucking, LLC, Truck Driver still would
have no immunity from liability for negligently driving the truck.

**Exposure to personal liability for wrongful conduct is less likely to exist when there is a valid contract between the Limited Liability Entity and the potential plaintiff.** The *White* decision highlights the potential for personal liability of a business owner for torts such as negligence or fraud. Importantly, though, North Carolina law treats breaches of contract, even intentional breaches of contract, differently than claims relating to torts.

In *White*, it was significant to the result of the case that a valid contract *did not exist* between the Whites and Collins Building, Inc., the business owned by Mr. Collins. That is because a specific legal theory in North Carolina generally prevents plaintiffs from recovering on tort claims when a valid contract regarding the relevant matter exists between the parties. When a valid contract exists, the parties are ordinarily limited to bringing breach of contract claims, rather than tort claims. However, there are many exceptions to this legal theory. For purposes of this article, it is sufficient to understand that the analysis undertaken by the Court of Appeals in *White* applies differently where a valid contract exists between the party harmed by the business owner’s own wrongful actions and the owner’s Limited Liability Entity.

**The legal concept discussed in *White* applies to all types of businesses and many types of conduct.** Although *White* specifically involved a negligence claim against the owner of a construction company that was a corporation, the legal concept underlying *White* applies to all types of businesses, all types of business entities, and many different types of wrongful conduct such as fraud, malpractice, misappropriation of trade secrets, interference with contract, and conversion of property. The following are examples of how this legal principle might operate in a variety of situations:

- The owner of a software company may be personally liable for fraudulent misrepresentations the owner makes to a customer about a software product sold by the company which causes damage to the customer’s information systems.

- The owner of an architectural firm who is an architect and who personally designs a project may be personally liable to a client of the firm for a negligent design which negatively impacts the drainage of a neighboring property.

- The owner of a financial services firm may be personally liable to the heirs of a former client of the firm for the owner’s personal mismanagement of the client’s accounts.

**Conclusion**

With the formation of Limited Liability Entities becoming more and more commonplace, it is important for business owners to have a clear understanding of what personal liabilities are shielded by such an entity and what risks for personal liability remain. The *White* decision makes clear that when a business owner actively participates in the operations of the owner’s business, the possibility for personal liability for the business owner’s own wrongful conduct exists. An owner’s awareness and understanding of this possibility for personal liability will prevent surprises and may help the owner to plan for this potential exposure to personal liability.

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*For further information regarding the issues described above, please contact Michael J. Parrish or Ryal W. Tayloe.*

* The authors successfully represented the Plaintiffs in *White* before the North Carolina Court of Appeals.

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