Single Purpose Limited Liability Companies for Liability Protection: A Word of Caution

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09.12.2017

It has become a fairly common practice among commercial and investment real estate owners to hold title to their various parcels in single purpose entities (?SPE?s?), most commonly limited liability companies (?LLC?s?). Many times, the use of an SPE is required by a lender or a government program. At other times, the SPE is necessary to merge the interests of multiple and varied investors. But, more often than not, the overarching reason for the use of an SPE is to shield individual LLC members from liability.

In North Carolina, LLC?s are governed by the North Carolina Limited Liability Company Act, which is found in Chapter 57D of the North Carolina General Statutes (N.C. Gen. Stat. § 57D-1-101, *et seq.*) Pursuant to N.C. Gen. Stat. § 57D-3-30, ?A person who is an interest owner, manager, or other company official is not liable for the obligations of the LLC solely by reason of being an interest owner, manager, or other company official.?

The Virginia counterpart is the Virginia Limited Liability Company Act, found in Chapter 13.1 of the Virginia Code (Va. Code Ann. § 13.1-1000, *et seq.*). Pursuant to Va. Code. Ann. § 13.1-1019, ?Except as otherwise provided by this Code or as expressly provided in the articles of organization, no member, manager, organizer or other agent of a limited liability company, regardless of whether the limited liability company has a single member or multiple members, shall have any personal obligation for any liabilities of a limited liability company, whether such liabilities arise in contract, tort or otherwise, solely by reason of being a member, manager, organizer or agent of a limited liability company.?

So, end of story, right? Form an LLC, take title in the name of the LLC, and by law all the members are protected, right? As famous football broadcaster Lee Corso would say, ?Not so fast, my friend!? While these state laws may create a presumption of liability protection for members, tort victims still have an equitable arrow in the quiver known as ?piercing the corporate veil.? This article will examine a recent North Carolina case involving the piercing of a network of SPE?s, and the lessons to be learned.

The case is Southern Shores Realty Services, Inc. v. William G. Miller, et al., ___ N.C. App. ___, 796 S.E.2d 340 (N.C. Ct. App. 2017). The plaintiff, Southern Shores Realty Services, Inc. (?SSRS?), is a real estate property management company headquartered in Southern Shores on the Outer Banks of North Carolina. The individual defendant, William G. Miller (?Miller?), is a real estate developer from Northern Virginia. During the mid-2000?s, at the height of the real estate market boom, Miller, along with his sons and wife, built or acquired no less than thirteen (13) residential vacation homes in Southern Shores and Duck, North Carolina (the ?Miller Homes?). Each home was titled in the name of an LLC (the ?Miller LLC?s?), and each home was placed in a vacation rental program with SSRS pursuant to executed management agreements.

The dispute was, at its heart, a contract action. As a standard industry practice, vacation management companies in North Carolina ?predisburse? rental deposits to the property owner, monies received from prospective tenants in the form of deposits on tenancies for the upcoming season. In the fall of 2009, the Miller LLC?s had received predisbursed rent from SSRS in the total amount of $74,221.79. In January 2010, SSRS learned that one of the properties it was managing for Miller had appeared on a list of foreclosure properties in Dare County.

The SSRS management agreement contained a clause that required property owners to report a foreclosure on their property and to return any predisbursed rental proceeds to SSRS. Neither Miller, nor any member of his family, nor any representative of the Miller LLC?s, had notified SSRS that any of the Miller Homes was going into foreclosure. Upon noticing the first Miller Home in foreclosure, SSRS contacted Miller seeking additional information and a return of the predisbursed rental proceeds. Miller claimed that he was engaged in a ?strategic default? in an effort to renegotiate with his various lenders, and that he was purposefully allowing the Miller Homes to go into foreclosure, with bankruptcy as a possible endgame. Miller argued that he did not have to return the predisbursed rents because none of the Miller Homes had yet been sold on the courthouse steps. SSRS took the position that ?foreclosure? in the management agreement meant the filing of foreclosure by a lender.

Several weeks passed and Miller continued to refuse to return any rental money. When the first of the Miller LLC properties was actually sold at foreclosure, with Miller still refusing to return any funds, SSRS declared breach, terminated its management agreements with all of the Miller LLC?s, and refunded the tenant deposits out of SSRS accounts. In the following months, all but two of the Miller Homes were sold on the courthouse steps.

SSRS filed suit seeking, *inter alia*, return of the funds and to pierce the veil created by the Miller LLC?s to hold Miller personally liable. Miller counterclaimed, alleging that SSRS had been the party in breach, and sought damages for lost rents on the Miller Homes for the upcoming season. The case was tried to a Dare County jury in October of 2015. The jury returned a verdict in favor of SSRS, finding that each of

the Miller LLC?s had breached its agreement with SSRS and caused damages in the full amount of the predisbursed rental amount. More significantly (since the Miller LLC?s were all SPE?s and their only assets had been lost in foreclosure), the jury found Miller himself personally liable for the damages. Miller appealed to the Court of Appeals.

Focusing on the issue of piercing the corporate veil, the Court of Appeals noted that avoiding the LLC structure to find a manager or member personally liable was a ?strong step: **Like lightning, it is rare and severe.**? The Court noted the three elements of proof required to pierce the veil: 1) Control of the entity, to the point of total domination; 2) Such control used to breach a duty; and 3) The control and breach are the proximate cause of the plaintiff?s injury. See Glenn v. Wagner, 313 N.C. 450, 329 S.E.2d 326, 330 (1985). Further, the Court identified four factors to be weighed in considering the evidence: 1) Inadequate capitalization; 2) Non-compliance with corporate formalities; 3) A level of domination and control such that the LLC has no separate identity; and 4) Excessive fragmentation of a single enterprise into many separate companies. Id.

The Court found that Miller had dominant control of the LLC?s. At trial, Miller testified that he was personally handling the affairs of the LLC?s, with a plan to turn management over to his son at some point. SSRS employees testified that they only dealt with Miller himself, never the sons or wife, and that Miller had asserted he would personally remain in control if bankruptcy was necessary. And perhaps most damning was a letter written in the early stages of the dispute by Miller?s lawyers, in which they frequently referred to Miller individually and interchangeably with the LLC?s.

Given that there were thirteen LLC?s for thirteen Miller Homes, and Miller further testified that he had formed ?30 or 40? LLC?s in his lifetime, all for the purpose of avoiding liability, the Court found excessive fragmentation of Miller?s business venture. The Court also found that, because Miller was contemplating placing the LLC?s into bankruptcy protection, and because the LLC?s had no assets other than the houses that were being lost in foreclosure, the LLC?s were inadequately capitalized. On the totality of this evidence, the Court of Appeals upheld the jury verdict, piercing the veil of the LLC?s and holding Miller personally liable for the breaches of the SSRS management agreements.

What lessons are there to be learned from the Miller case? First, devotion to company formality is a must, with particular care for a rigorous distinction between the company and its individual members and managers; here, even Miller?s lawyers confused the man with his companies. Second, depending on the venture, consider whether multiple property holding companies are necessary; using an SPE may be unavoidable depending on lender or program requirements, but in this case Miller fractured his business for the admitted purpose of evading liability. Finally, understand the importance of capitalization of the SPE, recognizing that walking a capitalization tightrope might expose individual members or managers to potential liability.

Ultimately, this is a case of the courts seeking to do equity to redress a wrong. If the fact pattern had been different, perhaps the jury and the Court of Appeals would have struggled more to pierce the veil. But Miller?s hubris was his undoing, making the Court?s decision easy. It is important that investors and developers understand that the LLC form of ownership is not a liability panacea, and that titling investment property in an LLC does not guarantee that lightning will not strike.

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