

# Court Rulings Enhance LLCs as Business Entity

Recent rulings from the North Carolina Court of Appeals in two unrelated cases have enhanced the use of a limited liability company or LLC as a business entity, provided the operating agreement is drafted properly.

A North Carolina LLC may have a written operating agreement, an oral operating agreement, or no operating agreement at all. In the absence of an operating agreement, the LLC Act sets forth the basic provisions that govern the LLC's formation, management, and dissolution. These are sometimes referred to as the Adefault provisions. However, this pair of cases demonstrates the substantial benefits of having a properly drafted written operating agreement. When drafted appropriately, a written operating agreement can effectively shift liabilities between and among the members of the LLC without creating duties to anyone other than the parties to the agreement.

As a result of recent decisions in the cases of *Babb v. Bynum and Murphrey, PLLC* and *Spaulding v. Honeywell*, it is clear that properly drafted operating agreements do not create a duty to persons who are not parties to the operating agreement. This is important because it assures the LLC's members the freedom to add terms and conditions as business conditions require, without the fear of



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creating a source of liability to persons outside the LLC. Further, in the context of a professional practice, absent direct knowledge of or participation in another member's wrongful conduct, other members of the professional practice have no duty to investigate such conduct, and should not be held liable for a fellow member's professional negligence. While the facts in *Babb v. Bynum* concerned claims of embezzlement, fraud, and breach of fiduciary duty, the rationale should apply with equal weight to a host of other potential claims as well.

In *Babb v. Bynum & Murphrey, PLLC*, the court ruled that an attorney who was a partner at a law firm, was not liable for his partner's embezzlement of a client's funds where the attorney had no direct knowledge of his partner's wrongful actions. The court further held that the LLC Act did not require the attorney to investigate the acts of his partner absent some actual knowledge of his partner's wrongdoing. The court further held that the law firm's operating agreement did not create a duty on the part of the attorney.

In *Spaulding v. Honeywell International, Inc.*, which was decided a few months after *Babb v. Bynum*, the court held that absent an independent duty, the mere participation of a member of a LLC in the LLC's business was

insufficient to hold the member independently liable for harm caused by the LLC.

In *Spaulding*, *HoltraChem GP, Inc.* and *Honeywell International, Inc.* formed a manager-managed LLC, *HMC LLC*, under North Carolina's LLC Act to operate a chemical manufacturing plant. *HoltraChem* and *Honeywell* were each members of the LLC. After the plant closed, sixty-five employees sued *HMC LLC* and its members, for claims arising out of alleged exposure to mercury, chlorine gas, and other hazardous materials. The court held that the LLC's operating agreement, which allocated certain liabilities to a non-manager member of the LLC, in this case *Honeywell*, could not be used as a basis for liability for claims by the employees because they were not parties to the operating agreement and the operating agreement did not name the employees as beneficiaries of that agreement. LLCs are not one-size fits all. To achieve these and other benefits, the LLC must be structured and run in proper manner. To make sure your operating agreement is properly drafted consult your legal and tax advisors.

After all, court is the last place you want to find out your operating agreement is not the best it could be.

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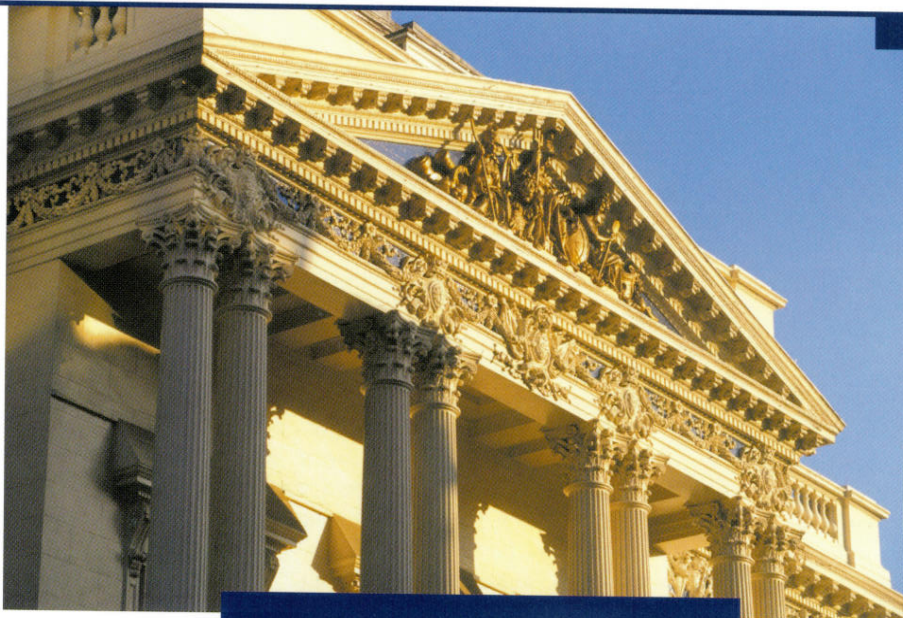
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