

LLC Managers Beware: N.C. Responsible Person Liability

By Clark Lacy and Christopher Hannum

I. Introduction

North Carolina requires business entities to collect sales, use, and other so-called trust fund taxes. In 2011 sales and use taxes accounted for over 35% of North Carolina's tax revenues. *See* Rudy Telles, Sheila O'Sullivan & Jesse Willhide, U.S. Census Bureau, State Government Tax Collections Summary Report: 2011, at 6 (2012). With such an impact on the State's bottom-line, it should be no surprise that the North Carolina tax code (the "N.C. Tax Code") may hold an LLC's owners and officers strictly liable for the company's failure to remit trust fund taxes. *See* G.S. § 105-242.2. Due to the potential reach of this liability, an unaware manager of an LLC may be penalized for actions beyond his or her control.

As a general matter, a party collecting trust fund taxes is not primarily liable for the payment of the tax. Rather, trust fund taxes are imposed on the other party to the transaction, such as an employee receiving wages or a customer purchasing goods. When the employer or seller withholds or collects the trust fund tax, the employee's or purchaser's liability for that tax is generally extinguished. *See* G.S. §§ 105-163.10 (crediting withheld wages against individual income tax), 105-164.7 (stating sales tax should be "borne by the purchaser instead of by the retailer"). Although the collecting party holds legal title to the collected trust fund taxes, the State is the beneficial owner. *See* G.S. §§ 105-163.2(a), 105-164.7. As a result, the collecting party is obliged to remit to the State the collected trust fund taxes in a timely fashion. If the collecting party fails to remit or collect the trust fund taxes, then a "responsible person" of the collecting party may be liable for an amount equal to those taxes. *See* G.S. § 105-242.2.

Unlike the federal responsible person statute, which looks to a party's authority and control over the collecting entity, the N.C. Tax Code defines a responsible person by reference to her title. Specifically, G.S. § 105-242.2(a)(2)(b)'s definition of responsible person simply includes "a manager of a limited liability company or partnership." As a result, North Carolina's statutory language appears to impose responsible person liability without regard to a party's knowledge of the business's failure to remit the trust fund taxes or duty to ensure compliance. Rather, the N.C. Tax Code only asks whether a party is a "manager." *Id.* This is an important distinction of which many managers are unaware and can create a large financial trap for those serving as manager. Despite responsible person liability hinging on a party's status as "manager," the N.C. Tax Code fails to define that term. Thus, the critical issue for determining the scope of the responsible person statute with respect to LLCs is determining who is a "manager."

II. Defining "Manager"

The N.C. Tax Code's failure to define the term "manager" results in responsible person liability becoming a matter of statutory construc-

tion. Two candidates exist to resolve this interpretive dilemma. First, an everyday, dictionary-based definition of the term "manager" may apply. This definition would look to a person's actions and authority rather than merely his title. Alternatively, one may use the LLC Act's definition of "manager." Under this approach, the inquiry is merely whether the LLC Act's requirements are satisfied rather than a person's actual acts or authority with respect to the business. While there are arguments for applying either approach, they are both far from bulletproof. Thus, as described below, non-active managers, especially those with deep pockets, should take protective measures.

a. Standard for Statutory Interpretation

The North Carolina courts have provided various interpretive rules that help frame the discussion of the appropriate definition of "manager" in the responsible person statute. The overarching "principle of statutory construction is that the intent of the legislature is controlling." **State ex rel. Utils. Comm'n v. Public Staff N.C. Utils. Comm'n**, 306 S.E.2d 435, 443 (N.C. 1983). Legislative intent "is first ascertained from the plain words of the statute." **Elec. Supply Co. v. Swain Elec. Co.**, 403 S.E.2d 291, 294 (N.C. 1991). To ascertain the plain meaning of the responsible person statute, the word "manager" should "be given [its] ordinary meaning, unless it appears from the context, or even otherwise in the statute, that another and different sense was intended." **Abernathy v. Bd. of Comm'rs**, 86 S.E. 577, 579 (N.C. 1915).

If the plain meaning is unclear, then "manager" as used in the responsible person statute is presumed to have the same meaning as that term is used in related statutes. **Campbell v. First Baptist Church**, 259 S.E.2d 558, 563 (N.C. 1979). Nevertheless, no definition should "be applied to the point of producing 'absurd results.'" **Secretary of Revenue, v. Jefferson-Pilot Life Ins. Co.**, 589 S.E.2d 179, 181 (N.C. Ct. App. 2003). Moreover, a statute should always be construed "in a manner which will tend to prevent it from being circumvented." **Campbell**, 259 S.E.2d at 484. Importantly, the term "manager" under the N.C. Tax Code should arguably be "strictly construed against the State and in favor of the taxpayer." **Watson Indus., Inc. v. Shaw**, 69 S.E.2d 505, 511 (N.C. 1952).

b. Plain Meaning of "Manager"

The N.C. Tax Code states that "[a] manager of a limited liability company or a partnership" is a responsible person. G.S. § 105-242.2(a)(2)(b). However, the N.C. Tax Code fails to define "manager" in this context. When faced with an undefined statutory term, North Carolina courts have looked to the term's dictionary definition to de-

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termine its plain meaning. *In re Murdock*, 730 S.E.2d 811, 813-14 (N.C. Ct. App. 2012) (using *Black's Law Dictionary* to define “violent crime”). *Black's Law Dictionary* defines the term “manager” as “[a] person who administers or supervises the affairs of a business, office, or other organization.” Under this definition, a party’s authority and control determines her status as a manager and responsible person rather than her official title. Notably, this definition is in accord with the federal responsible person statute. See I.R.C. § 6672(a).

Under IRC § 6672, a party is a responsible person only if she is required to collect, truthfully account for, and pay over a tax. Courts applying IRC § 6672 have held that the responsible person inquiry is determined under all of the facts and circumstances. See *O'Connor v. United States*, 956 F.2d 48, 51 (4th Cir. 1992). Although high-ranking officers such as LLC managers are often responsible persons, there is no per se rule or presumption that all managers are responsible persons based solely on their title. *Id.* at 51. Rather, federal courts have looked to various factors to determine whether the party has the requisite control and authority over the business’s finances and general decision-making. Factors showing authority to make substantive business decisions receive more weight than mechanical duties like signing the business’s checks. Moreover, if a party holds a specific title, then the party’s purpose in accepting the title is examined. *Id.* at 51-52. Thus, under federal law, it is unlikely that an investor would be considered a responsible person if he exercises no control over an LLC but merely holds the title of manager.

Although the federal responsible person analysis is in accord with the plain meaning of “manager,” other provisions of the N.C. Tax Code’s definition of responsible person suggest that the federal analysis should not be applied in this context. Specifically, an LLC member (as opposed to a manager) is considered a responsible person under the N.C. Tax Code only if she “has a duty to deduct, account for, or pay” trust fund taxes. G.S. § 105-242.2(a)(2)(c). This limiting language is nearly identical to the federal definition of responsible person and shows that the legislature was aware and capable of defining “responsible person” by reference to a party’s control and authority. The absence of such a limitation in the manager provision suggests that the legislature intended any manager to be a responsible person regardless of his control or authority over the LLC.

Indeed, this unlimited manager provision survived the significant 2008 revision of the N.C. Tax Code’s responsible person statute. Prior to the 2008 revision, responsible person liability attached to “the manager of a limited liability company, and any other . . . member of a limited liability company who has a duty to deduct, account for, or pay” trust fund taxes. See N.C. Session Law 2008-134 § 10.(a). Under this former language, North Carolina courts only considered the party’s title rather than looking to the extent of its authority and control. See *Petition of Jonas*, 318 S.E.2d 869, 870-72 (N.C. Ct. App. 1984). It appears that the legislature and the courts have implicitly decided that a party merely holding the title of manager is a responsible party regardless of his duties and obligations to the LLC.

c. “Manager” Under the LLC Act

If the title of manager is the crucial inquiry in determining whether someone is a manager for purposes of the responsible person act, then the analysis should focus on the North Carolina Limited Liability Company Act’s (the “LLC Act”) definition of manager. The LLC Act defines manager as “any person *designated* in, or in accordance with, [G.S.] § 57C-3-20(a).” G.S. § 57C-1-03(13) (emphasis added). In turn, § 57C-3-20(a) states that for a manager-managed LLC, all “persons *designated* as managers in, or in accordance with, the articles of organization or a written operating agreement shall be managers.” Consequently, the critical inquiry under the LLC Act is whether a party is “designated” as a manager in a written operating agreement. But what does it mean to be “designated”?

The LLC Act does not set forth any definitions or requirements for designation except that it must occur in a written operating agreement or the articles of organization. Applying the common definition of “designate,” a manager is any person a written operating agreement indicates and sets apart for the specific purpose of being manager of the LLC. Moreover, under the LLC Act a party’s designation as manager and such party’s consent to the designation are independent events. See G.S. § 57C-3-21(3). Consequently (and disturbingly), it appears that the effectiveness of the designation is not dependent upon the party’s consent. These traits raise the issue of whether the parties to an LLC operating agreement may limit or expand the definition of manager, and thus, alter the class of responsible persons.

On January 1, 2014, the LLC Act will be repealed and replaced with a new Chapter 57D (the “New LLC Act”). N.C. Sess. Law 2013-157 (enacting Senate Bill 439). The New LLC Act does not resolve any of the aforementioned issues with applying the LLC Act’s definition of manager to the responsible person statute. See G.S. §§ 57D-1-03(20), 57D-3-20(a), 57D-3-21(3) (effective Jan. 1, 2014). Also, the New LLC Act creates an additional issue in this context. Specifically, the New LLC Act provides for the new position of “company official,” which is defined as any person exercising any management authority over the LLC. G.S. § 57D-1-03(5). A party may be a company official without being named a manager, and an LLC may have no party designated as a manager. In the session law enacting the New LLC Act, there is no revision to the responsible person statute adding “company official” to the definition of responsible person. Thus, it may be possible for the party exercising management authority over an LLC to avoid responsible person liability merely by being designated company official rather than manager.

As described in the following examples, the LLC Act’s deference to the operating agreement as well as inconsistencies between the LLC Act and the responsible person statute may create some peculiar results. In each of these examples, two North Carolina individuals—Investor and Service Provider—form an LLC to start a new restaurant. Under Investor and Service Provider’s deal, each will receive an equal interest in the LLC. Moreover, Investor will be a passive member, only providing capital to the venture, while Service Provider will be responsible for overseeing the LLC’s operations. After two years of operating, Investor and Service Provider shut down the restaurant.

During the last six months of operations, instead of remitting the collected sales taxes to the State, the restaurant used these funds to pay vendors and employee wages.

Example 1. Assume the restaurant's operating agreement names both Investor and Service Provider as the LLC's managers despite the parties' unwritten understanding that Investor will not take any active role in management. Moreover, the operating agreement names Service Provider as the tax matters partner. Under these facts, it appears Investor will be considered a manager of the restaurant under the LLC Act. The parties' understanding as to Investor's role should not change this result because the LLC Act requires the manager designation to be made in a written operating agreement. G.S. § 57C-3-20(a). As a result, it is unlikely an oral agreement would trump the written designation.

If the N.C. Tax Code's responsible person statute applies the LLC Act's definition of manager, the Investor would be considered a responsible person and would be "personally and individually liable" for the restaurant's unremitted sales taxes. G.S. § 105-242.2(b)(1). Consequently, Investor may be held liable for all of the unremitted taxes. Investor's liability is the result of her status as manager rather than her actions or conduct. The LLC Act clearly states that Investor is not liable for the LLC's obligations solely because she is a manager. See G.S. § 57C-3-30(a). Rather, Investor only becomes personally liable for such obligations through her actions or conduct. Under the LLC Act, if the theory of liability is a manager's failure to act, the manager must have actual knowledge of the malfeasance to become personally liable. See **Babb v. Bynum & Murphrey, PLLC**, 643 S.E.2d 55, 57 (N.C. Ct. App. 2007).

Based on this general limitation of liability, the N.C. Tax Code's responsible person statute is in conflict with the LLC Act in the case of Investor. Arguably, this apparent conflict may be resolved by the N.C. Tax Code's responsible person statute's holding each responsible person "personally and individually liable." That is, the responsible person statute imposes an obligation independent and separate from the manager's potential liability. However, that interpretation is unpersuasive because the manager's liability arises only after the LLC fails to pay the trust fund taxes. A manager, in effect, guarantees payment of the trust fund taxes solely because she is a manager. This presumed guarantee is contradictory to the LLC Act's general limitation of liability.

Nevertheless, in addition to the general limitation of liability, another provision of the LLC Act states that the liability of a domestic LLC's manager "shall at all times be determined solely and exclusively by [the LLC Act] and the laws of this State." G.S. § 57C-3-30(c). Thus, the LLC Act contemplates that a manager may be liable under another provision of North Carolina law, such as the N.C. Tax Code's responsible person statute. However, no guidance is given for situations where the N.C. Tax Code's responsible person statute (or any other law) conflicts with the LLC Act. The principles of statutory construction should apply to resolve this conflict.

Generally, "when two statutes arguably address the same issue, one in specific terms and the other generally, the specific statute controls." **High Rock Lake Partners, LLC v. N.C. Dep't of Transp.**, 735 S.E.2d 300, 305 (N.C. 2012). In other words, the specific statute is treated as an exception to the general statute. However, if it ap-

pears that the legislature did not intend for the specific statute to be an exception to the general statute, the general statute will govern. See **Banks v. County of Buncombe**, 494 S.E.2d 791, 795 (N.C. Ct. App. 1998). Such intent may exist where the legislature specifically provides an exception in the general statute. See **Barnhardt v. Yellow Cab Co.**, 146 S.E.2d 479, 485 (N.C. 1966), overruled on other grounds by, **Derebery v. Pitt County Fire Marshal**, 347 S.E.2d 814, 817-18 (N.C. 1986). In such circumstances, the two statutes should be interpreted in a non-conflicting manner. See **Taylor v. Robinson**, 508 S.E.2d 289, 291 (N.C. App. 1998).

As noted above, the LLC Act provides a general rule that a manager is not liable for an LLC's obligations. Moreover, the LLC Act specifically excepts from this general rule cases where the LLC's obligations arise from the manager's actions or conduct. Because the legislature limited the scope of the LLC Act's general provision with a specific exception, it arguably did not intend for any other exceptions, such as the N.C. Tax Code's responsible person statute, to apply. The LLC Act's general limitation of liability and the N.C. Tax Code's responsible person statute should be applied to avoid this conflict. One non-conflicting interpretation is that the term "manager" as used in the responsible person statute should only include managers who had knowledge of the LLC's failure to remit trust fund taxes and failed to act as the federal statute provides. See **Babb**, 643 S.E.2d at 57.

Example 2. Once again, Investor and Service Provider start a new restaurant. While Service Provider is named manager and the tax matters partner, Investor receives no management rights in the operating agreement. Moreover, although Investor and Service Provider have never met Governor McCrory, they name him manager in the operating agreement based on their high regard of his economic policies. The operating agreement states that a manager's term shall begin upon designation and end upon his resignation. The restaurant breaks even in its first year. In its annual report for that year, Service Provider and Governor McCrory are listed as the LLC's managers. In year two, however, the restaurant becomes unprofitable. During the final six months of operations, Service Provider uses the collected sales taxes to pay employee wages and vendors rather than remitting the funds to the State. In addition, Investor made a number of other questionable investments that did not pan out. When the restaurant is shuttered, Investor and Service Provider are on the verge of bankruptcy, and the LLC owes the State tens of thousands of dollars in unpaid sales taxes.

Here, the State has no recourse against Investor because she is merely a member of the LLC. Service Provider is a responsible person because he is designated as manager of the LLC as well as the tax matters partner of the LLC. Nevertheless, because Service Provider is insolvent, pursuing him for the unpaid sales taxes would, at best, be a Pyrrhic victory for the State. As a result, the issue becomes whether Governor McCrory could be liable. The State should have no recourse against Governor McCrory: he did not know Investor or Service Provider, he had no involvement whatsoever with the LLC, and he had no knowledge of his designation as manager. Yet, if the LLC Act is literally applied, Governor McCrory would be a responsible person.

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First, the LLC Act provides that “[a]ny person dealing with a limited liability company . . . may conclusively rely upon its most recent annual report . . . as to the identity of its managers. . . .” G.S. § 57C-3-25(a) (emphasis added). The State is likely a “person” for purposes of this conclusive presumption. See, G.S. § 57C-1-03(17). Specifically, the LLC Act’s definition of the term “person” includes any entity, and presumably the State is an entity. Because the restaurant holds the sales taxes in trust for the State, the State is likely “dealing with” the LLC. Consequently, the State should be able to conclusively treat Governor McCrory as a manager of the restaurant. Based on this conclusive presumption, Governor McCrory would be a responsible person.

In addition to the conclusive presumption, Governor McCrory would be a responsible person if the LLC Act’s definition of manager is literally applied. Specifically, the definition of responsible person does not explicitly require him to be actively involved with or have knowledge of the LLC; rather, it merely requires him to be a manager. Moreover, the LLC Act provides that Governor McCrory is a manager merely because Investor and Service Provider designated him as such in the operating agreement. Thus, under a literal application of the responsible person statute and LLC Act, Governor McCrory would be liable for the LLC’s unremitted sales taxes.

Clearly, holding Governor McCrory liable as a responsible person under these facts would be inappropriate. However, barring administrative grace, there appears to be little statutory relief. Unlike the federal responsible person statute, a responsible person is strictly liable for unpaid trust fund taxes under the N.C. Tax Code. Governor McCrory’s lack of knowledge or intent is irrelevant under the N.C. Tax Code’s responsible person statute. Moreover, it is unlikely that equity would prevent him from being classified as a manager under the LLC Act. Because the LLC Act defines the term “manager,” it is unlikely that a court would look to equity to remove Governor McCrory from that statutory definition. Thus, a literal application of the LLC Act to define “manager” under the responsible person statute results in the absurd outcome of holding a person with no knowledge or connection to the LLC liable for the LLC’s unremitted trust fund taxes.

Example 3. Investor and Service Provider decide to start a restaurant as a fifty-fifty LLC. Rather than holding his interest in the restaurant directly, Service Provider acquires his 50% LLC interest through a wholly-owned S corporation (“Corporation”). In addition to being Corporation’s sole-shareholder, Service Provider is its president and only employee. Service Provider has invested in other ventures through Corporation in the past, but currently Corporation’s only assets are its ownership interest in and services contract with the restaurant. The LLC’s operating agreement names Corporation as both its manager and tax matters partner. When the restaurant ceases operations, Corporation is insolvent, but Investor and Service Provider have assets in excess of the LLC’s outstanding tax liabilities.

Similar to Investor and Service Provider in *Example 2*, the state is unlikely to pursue Corporation due to its insolvency. As a result, the State’s only recourse, if any, is against Investor or Service Provider. Like in *Example 2*, the State likely does not have a claim against Investor because she was not a manager (under any definition) of the LLC

and did not have the responsibility for remitting the taxes. Thus, the State may attempt to treat Service Provider as a responsible person.

The N.C. Tax Code’s responsible person statute only applies to certain trust fund taxes; it does not apply to a responsible person of an entity that has responsible person liability for another entity. Although Corporation is a responsible person with respect to the LLC’s trust fund taxes, Corporation’s responsible person liability arising from this relationship is not considered a trust fund tax. See G.S. § 105-242.2(b). As a result, Corporation effectively blocks Service Provider from being considered a responsible person of the LLC despite Service Provider’s being a responsible person of Corporation and Corporation’s being a responsible person of the LLC. Consequently, it appears that the responsible person statute only applies to a direct responsible person (like Corporation with respect to the LLC) rather than an indirect responsible person (like Service Provider with respect to the LLC). To hold Service Provider liable, the state must show that he was directly a responsible person of the LLC.

Applying the plain meaning approach, Service Provider would likely be a responsible person. He was the individual with the duty to account and remit the trust fund taxes, and he knowingly failed to do so. Conversely, applying the LLC Act’s definition of manager, Corporation is the only responsible person. The State could attempt to enforce Corporation’s liability against Service Provider under a piercing or alter-ego theory. However, such an argument would likely fail assuming Service Provider respected corporate formalities, had a valid business purpose for using Corporation, and did not siphon funds from Corporation. Thus, if the LLC Act’s definition applies, it appears the responsible person statute may be avoided by naming a corporation rather than an individual as manager of the LLC.

III. Conclusion

In sum, the N.C. Tax Code’s responsible person statute may penalize an unwary manager for acts outside his control due to its potential breadth. Unlike the federal responsible person statute, the North Carolina law arguably holds a manager liable merely because of her title rather than her culpability. As a result, to avoid unintended and potentially inequitable results, any person serving as a manager of an LLC doing business in North Carolina should diligently monitor and ensure that the company’s trust fund tax liabilities are satisfied. •

Clark Lacy and **Chris Hamm** are attorneys with Culp Elliott & Carpenter, P.L.L.C. in Charlotte.