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IS THERE A SELF-DEALING EXCEPTION TO THE BUSINESS-JUDGMENT RULE FOR VIRGINIA LLCS?

In Virginia, corporate directors who transact business with the corporation generally have the burden to demonstrate that such a transaction is fair and reasonable to the corporation.[1] For instance, when corporate directors also serve as officers and set their own salaries, shareholders may bring a claim for breach of fiduciary duty against those directors and recover on behalf of the corporation if the directors cannot prove the compensation is fair and reasonable.[2] This burden-shifting principle is an exception to the general presumption that directors of a corporation act properly and in the good-faith exercise of their business judgment in making decisions for the corporation (the "self-dealing exception").[3]

The Supreme Court of Virginia has "stated that a manager of a [limited liability company ("LLC")] is like a corporate director and analogized the fiduciary duties of managers in an LLC to the fiduciary duties of corporate directors."[4] Some may assume the fiduciary duties owed by managers of an LLC, and the burdens and presumptions that apply to them, are identical to the principles developed at common law to govern the conduct of corporate directors (like the self-dealing exception discussed above). However, this analogy does not necessarily hold in all circumstances, particularly as it relates to transactions between LLC managers and the LLC.

Because of a provision in the Virginia Limited Liability Company Act (the "LLC Act") – a provision without counterpart in the Virginia Stock Corporation Act (the "VSCA") – the default rule in Virginia likely is that a member who transacts business with the LLC does not have to prove the transaction was fair and reasonable to the LLC. Rather, like other managerial actions challenged by members of the LLC, the burden to demonstrate a breach of fiduciary duty is on the challenging members. Unfortunately, this provision has not yet been addressed in a reported decision by Virginia courts, and commentators have urged an opposite interpretation, making the existence of a self-dealing exception in the LLC context uncertain.

Fortunately, like most provisions in the LLC Act, the provision in question establishes a default rule that can be changed by the members in the LLC's organizing documents if they wish. As explained below, in light of the uncertainty

BY CHRISTOPHER PICKENS

around the self-dealing exception, members establishing LLCs in Virginia would be wise to set out in their organizing documents the standard they want to govern so-called self-dealing.

THE CORPORATE SELF-DEALING EXCEPTION

Under Section 13.1-690 of the VSCA, a corporate director is protected from liability for decisions made on behalf of the corporation provided that in making those decisions he or she acted in good faith and in the exercise of his or her business judgment.[5] Section 13.1-690(D) further provides that a person alleging a violation of this standard by a corporate director has the burden to prove the alleged violation.[6]

However, the Supreme Court of Virginia twice has held that the burden shifts to corporate directors in cases that involve self-dealing or conflicts of interest. First, in *Giannotti v. Hamway*, a case filed before Section 13.1-690 went into effect, the Supreme Court stated that directors are presumed to have acted in good faith in making decisions on behalf of the corporation unless they engaged in self-dealing or fraud or acted in bad faith.[7] *Giannotti* involved a challenge to compensation that directors set for themselves, and the Supreme Court, applying a common-law self-dealing exception, held that the director defendants were not entitled to the presumption of good faith under those circumstances.[8] Instead, the directors had the burden to demonstrate that their compensation was fair and reasonable to the corporation.[9] More recently, in *Izadpanah v. Boeing Joint Venture*, the Supreme Court held that, in cases involving a conflict of interest as defined in Section 13.1-691 of the VSCA, "the burden shifts to the directors to show that their actions complied with the requirements of that section."[10] In doing so, the Court cited its common-law holding in *Giannotti*. *Giannotti* and *Izadpanah* establish in the corporate context an exception to the business-judgment rule for transactions between directors and the corporation.

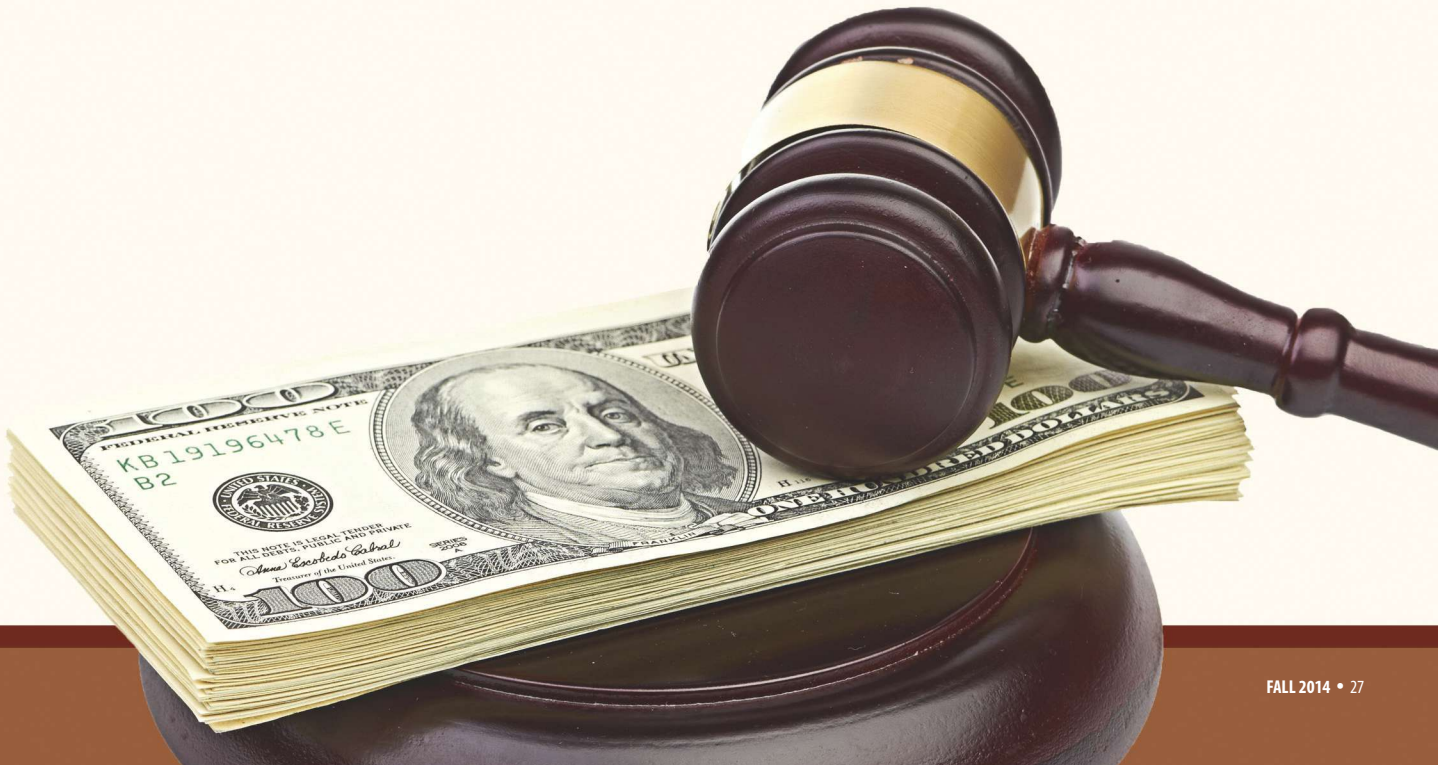
MEMBER OR MANAGER TRANSACTIONS UNDER THE LLC ACT

The same is not necessarily true for managers or managing members of an LLC. Although Section 13.1-1024.1 in the LLC Act sets forth a business-judgment standard almost identical to Section 13.1-690,[11] another provision in the LLC Act seemingly forecloses the self-dealing exception in the LLC context. Specifically, Section 13.1-1026 provides:

> Except as provided in the articles of organization or an operating agreement, a member or manager may lend money to and transact other business with the limited liability company and, subject to other applicable law, has the same rights and obligations with respect thereto as a person who is not a member or manager.[12]

Based on its plain language, this provision is difficult to harmonize with the self-dealing exception found in the corporate context: If the self-dealing exception applied to LLCs, a member or manager transacting business with the LLC would not have "the same rights and obligations with respect thereto as a person who is not a member or manager." To the contrary, the member or manager would bear the burden of proving that the transaction was fair and reasonable to the LLC and could face liability if he or she cannot meet that burden, while for other transactions involving the LLC, the challenging members would have to overcome the business-judgment presumption.

Nonetheless, one well-respected treatise has advocated a narrower reading of Section 13.1-1026, one that would not eliminate the self-dealing exception for LLCs.[13] Seven other states have provisions like Section 13.1-1026.[14]



These "same rights" provisions can be traced back to Section 107 of the Revised Uniform Limited Partnership Act ("RULPA"), which contained a similar provision. According to the treatise's authors, because the RULPA's advisory comment to that original section discusses its effect only in certain bankruptcy or insolvency situations, and does not address the self-dealing exception, same-rights provisions like Section 13.1-1026 should not be read to "legitimize" self-dealing for LLC managers.[15] The authors also note that a contrary reading of these same-rights provisions would invite abuse by LLC managers.[16]

For several reasons, however, the better interpretation of Section 13.1-1026 probably is that it eliminates the self-dealing exception. First, Virginia adheres to the plain-meaning rule of statutory interpretation,[17] and the plain language of the statute provides that members or managers "have the same rights and obligations with respect [to transactions with the LLC] as a person who is not a member or manager." As noted above, that would not be the case if there were a self-dealing exception for LLC managers.

Second, in holding in *Izadpanah* that the self-dealing exception applied to corporate directors, the Supreme Court cited Section 13.1-691 in the VSCA.[18] Section 13.1-691 defines "conflict of interests transaction" and identifies procedures that interested directors need to follow to prevent those transactions from being voidable by the corporation.[19] The LLC Act does not contain a provision comparable to Section 13.1-691. Rather, Section 13.1-1026 provides almost the opposite. Instead of creating a distinction between interested transactions and all others, it disavows such a distinction.

Third, the advisory comment to Section 107 of RULPA, relied upon by the treatise's authors, says nothing to exclude the self-dealing exception from the same-rights provision's scope.[20] The advisory comment explains the provision eliminates a fraudulent-conveyance rule, created in an earlier version of the Uniform Limited Partnership Act, concerning loans to the partnership by limited partners. According to the advisory comment, those situations should be addressed by bankruptcy or insolvency laws and not the provisions in the earlier Act (which likely explains the phrase "subject to other applicable law" in Section 107 of RULPA).[21] To be sure, the advisory comment clarifies that one purpose of Section 107 was to reverse insolvency rules created by the earlier act, but the comment does not say the broad language of the provision was intended to apply just in that circumstance.[22]

Finally, although it is possible, as the treatise notes, that LLC managers might be more likely to take advantage of their positions in the absence of a self-dealing exception to the business-judgment rule, similar risks also attend the opposite rule. Disgruntled non-manager members might be more likely to bring dubious lawsuits against managers knowing that the managers would bear the burden of defending their actions, distracting managers and harming the LLC's business.[23] LLCs provide flexibility for their members and managers, as well as certain features of corporations and of partnerships,[24] and as a result, they come in all shapes and sizes, from small, family businesses to large, professionally managed ones. The proper balance of risks associated with self-dealing will vary based on the situation and the preferences of the members. Thus, the presence of risks associated with one interpretation of Section 13.1-1026, viewed in isolation, does not undermine that interpretation, particularly when the interpretation is based on the statute's plain language.

LLC MEMBERS CAN AND SHOULD RESOLVE THE UNCERTAINTY

Regardless of which interpretation of Section 13.1-1026 one finds more persuasive, no reported decision in Virginia has determined the effect Section 13.1-1026 has on a self-dealing exception for managers of an LLC,[25] and members cannot now know which interpretation of Section 13.1-1026 Virginia courts will adopt. However, the LLC Act gives members the power to resolve the uncertainty themselves. As set out above, Section 13.1-1026, by its own terms, does not apply if otherwise "provided in the articles of organization or an operating agreement." More generally, the LLC Act provides that it "shall be construed in furtherance of the policies of giving maximum effect to the principle of freedom of contract and of enforcing operating agreements."[26] Thus, it is clear that the rule in Section 13.1-1026, whatever courts might interpret it to be, is a default rule that can be altered by the parties.

Members should address this issue in their operating agreement in light of their particular circumstances. In small and/or family-owned LLCs, where managers or managing members typically set their own compensation and therefore engage in so-called self-dealing as a matter of course, the risk of dubious member suits may be a greater concern: The non-manager members will always have a self-dealing transaction to challenge and the distraction of a lawsuit will be greater with fewer employees to shoulder the burden of litigation. If that is the case, members probably will want to ensure that so-called self-dealing (or at least specific examples of it) is afforded the protection of the business-judgment rule under the operating agreement. In contrast, larger businesses with professional, nonmember managers and less involved members may view improper self-dealing as the greater concern, in which case the members will want to make clear in the operating agreement that the self-dealing exception applies and that the business-judgment presumption does not protect transactions between managers and the LLC.

Although these generalizations may not be consistent with the desires of members in a particular LLC, members nonetheless should address the issue and set out in the operating agreement the standard that will apply to transactions between managers and the LLC. For the time being, that looks like the only way members can be certain about which standard applies. ■

Endnotes

1 *Izadpanah v. Boeing Joint Venture*, 243 Va. 81, 83, 412 S.E.2d 708, 709 (1992) (citing *Giannotti v. Hamway*, 239 Va. 14, 24, 387 S.E.2d 725, 731 (1990)).

2 *Giannotti*, 239 Va. at 24, 387 S.E.2d at 731.

3 *Izadpanah*, 243 Va. at 83, 412 S.E.2d at 709; *Giannotti*, 239 Va. at 24, 387 S.E.2d at 731.

4 *See Remora Invs., LLC v. Orr*, 277 Va. 316, 321, 673 S.E.2d 845, 847 (2009) (quotations omitted).

5 Va. Code Ann. § 13.1-690(A) & (C).

6 *Id.* § 13.1-690(D).

7 *Giannotti*, 239 Va. at 24, 387 S.E.2d at 731.

8 *Id.*

9 *Id.*

10 *Izadpanah*, 243 Va. at 83, 412 S.E.2d at 709.

11 Va. Code Ann. § 13.1-1024.1.A; see also *Remora Invs.*, 277 Va. at 322, 673 S.E.2d at 847 (noting both provisions "have almost identical language").

12 Va. Code Ann. § 13.1-1026.

13 Carter G. Bishop & Daniel S. Kleinberger, Limited Liability Companies: Tax & Bus. Law § 10.03[1][b].

14 *Id.* § 10.03[1][b][i] (citing statutory provisions in Arizona, Colorado, Delaware, Illinois, Indiana, Maryland, New Mexico, and Virginia).

15 *Id.* § 10.03[1][b][ii] (citing RULPA § 107, Official Comment (1985)).

16 *Id.*

17 *Simpson v. Roberts,* 287 Va. 34, 40, 752 S.E.2d 801, 803 (2014) ("When the language of a statute is unambiguous, we are bound by the plain meaning of that language. We must give effect to the legislature's intention as expressed by the language unless a literal interpretation of the language would result in a manifest absurdity.") (citation omitted).

18 *Izadpanah*, 243 Va. at 83, 412 S.E.2d at 709.

19 Va. Code Ann. § 13.1-691.

20 *See* RULPA § 107, Official Comment (1985).

21 As noted above, "subject to other applicable law" also is found in Section 13.1-1026. This language should not be read to incorporate the common-law self-dealing exception. Even assuming that the self-dealing exception would apply to managers of an LLC in the absence of Section 13.1-1026, it does not seem reasonable to interpret a general reference to "other applicable law" to incorporate an inconsistent common-law principle – on the same issue – that would dramatically limit the express language of the provision. Or viewed differently, the self-dealing exception is not really "other" law at all; rather, it is an inconsistent approach to the same law or legal issue addressed by the statute. As a result, it is unlike the bankruptcy laws referenced in the advisory comment to Section of 107 of RULPA.

22 *See* RULPA § 107, Official Comment (1985).

23 The LLC Act allows a court to award expenses, including reasonable attorneys' fees, to the member if he or she is successful "in whole or in part, or if anything is received by the plaintiff as a result of a judgment, compromise or settlement of an action or claim." See Va. Code Ann. § 13.1-1045. The defendants also can receive expenses, including reasonable attorneys' fees, but only if the court concludes that the lawsuit was "commenced without reasonable cause or the plaintiff did not fairly and adequately represent the interests of the members and the limited liability company …" *Id.*

24 *See* 4B-4B-3 *Michie's Va. Jurisprudence on Bus.* § 4 ("Limited liability companies are a conceptual hybrid, sharing some of the characteristics of partnerships and some of corporations. The general purpose of forming a limited liability company is to create an entity that offers investors the protections of limited liability and the flow-through tax status of partnerships."); see also 54 C.J.S. *Limited Liability Companies* § 11 ("Management flexibility is one of the features of a limited liability company.").

25 The bankruptcy court for the Eastern District of Virginia has in a footnote cited Section 13.1-1026 for the following proposition: "members may, by express provision of the Virginia Limited Liability Company Act, transact business with a company of which they are a member on the same basis as a non-member." *See in re Garrison-Ashburn*, LC, 253 B.R. 700, 709 n.7 (E.D.Va. Bankr. 2000). Although this seems to support the plain-meaning interpretation, the question being decided there was whether the operating agreement was executory – it was not about the contours of fiduciary duties under Virginia law. *Id.* at 708-09.

26 Va. Code Ann. § 13.1-1001.1.(C).

Christopher Pickens is a litigation associate in the Northern Virginia office of Hogan Lovells US LLP. His practice focuses on complex commercial litigation, including corporate-shareholder and LLC-member disputes. He earned a bachelor's degree from Washington and Lee University and a J.D. from George Mason School of Law. He joined the VBA in 2005 and is a member of the VBA Civil Litigation Section.