

# Pre-Suit Demand Requirements in Virginia: Should Universal Demand Be Universal?

BY CHRISTOPHER T. PICKENS

The Supreme Court of Virginia has observed that "consistent application of commercial rules promotes predictability" and that businesses may opt-out of those rules when doing so is desirable.<sup>1</sup> But an inconsistency in the Virginia Limited Liability Company Act (the "LLC Act") makes that commercial statute unpredictable: it is unclear if the LLC Act always requires a member to demand action from the LLC's management before filing derivative claims on the LLC's behalf, or in the alternative, if the member can avoid making demand by alleging in his or her derivative complaint that such a demand would have been futile. This uncertainty was created in 1992, when the Virginia Stock Corporation Act (the "VSCA"), which is incorporated into the LLC Act, was amended to make pre-suit demand on Virginia corporations a universal requirement.<sup>2</sup> Because this uncertainty has several potentially negative effects, the LLC Act should be amended to clarify whether pre-suit demand on Virginia LLCs is universally required, as it is with Virginia corporations. As explained below, the more sensible approach may be to apply the same demand requirements to both corporations and LLCs—as was the case before the 1992 VSCA amendments. But because of a fundamental difference between corporations and LLCs—the former being a creature of statute, the latter being a creature of contract—an amendment to the LLC Act also could permit LLC members to opt out of the universal demand requirement through the LLC's articles of incorporation or operating agreement.

As a general matter, rules governing pre-suit demand dictate who - as between a shareholder or member plaintiff and management - has the right to control litigation brought on a company's behalf. If demand is universally required, a shareholder or member may initiate litigation on behalf of a company only after first demanding that its management do so. In response to a demand, management must determine whether the

proposed litigation is in the company's best interests, and then accept or reject the demand accordingly. If management refuses the demand, the plaintiff may only initiate litigation if he or she can allege that management did so wrongfully; alleging wrongful refusal, in turn, can be difficult because management's conclusion that litigation was not in the company's interest is protected by the business judgment rule.<sup>3</sup> In contrast, a demand-futility exception allows a plaintiff to proceed immediately to litigation in the name of the company, without first making demand on management, if that plaintiff can allege particularized facts that establish management would be incapable of considering the demand impartially—a situation that may arise if the potential claims challenge a transaction from which the managers benefited or face a substantial likelihood of liability.<sup>4</sup>

The rationale for universal demand is that it (1) provides the board of directors a pre-litigation mechanism to resolve problems underlying litigation, essentially functioning as a method of alternative dispute resolution; (2) eliminates costly litigation over directors' alleged interest in the potential claim, which previously had been necessary to establish demand futility but was only collateral to the merits of the claim itself; and (3) vests primary control over a company's claims in those who are statutorily responsible for managing the company's affairs, the directors.<sup>5</sup>

The present uncertainty about which pre-suit demand requirements apply to LLCs in Virginia can have several deterrent effects on commerce in the Commonwealth. For example, prospective members may have concerns, *ex ante*, about other members misappropriating the LLC's assets or business opportunities. The ordinary remedy against such abuse is a derivative claim. But absent clear rules governing who may initiate those claims and how those claims may be initiated, a prospective member cannot be certain he or she will have an adequate mechanism to redress that

abuse. Similarly, a prospective member may be concerned that another member will disrupt the LLC's operations by filing frivolous derivative claims, and given the uncertainty of the LLC Act's requirements, he or she will be uncertain if the LLC has sufficient control over those suits. In some instances, these uncertainties may deter prospective members from organizing - or joining an LLC already organized - in Virginia. Finally, *ex post*, neither an LLC member nor LLC management can know with certainty how a derivative claim should be initiated, potentially spawning additional litigation to determine the applicable demand rules, in addition to whether those rules were followed.

When it enacted the LLC Act in 1991, the General Assembly made clear that the demand requirement applicable to shareholder-derivative suits under the VSCA, which at that time included a demand-futility exception, also applied to member-derivative suits under the LLC Act. At that time, the LLC Act read:

*A member may bring an action in the right of a limited liability company to recover a judgment in its favor to the same extent that a shareholder may bring an action for a derivative suit under the Stock Corporation Act, Chapter 9 (§ 13.1-601 et seq.) of this title. Such action may be brought if members or managers with authority to do so have refused to bring the action or if an effort to cause those members or managers to bring the action is not likely to succeed. . . .*<sup>6</sup>

In 1992, however, the General Assembly amended the VSCA so that "[n]o shareholder may commence a derivative proceeding until...[a] written demand has been made on the corporation to take suitable action,"<sup>7</sup> thereby establishing universal demand, and eliminating the previously recognized demand-futility exception, for derivative claims brought on behalf of a Virginia corporation. Yet when the "extent [to which] a shareholder may bring an action for a derivative suit under the

[VSCA]" was changed in 1992, the LLC Act was not amended to make a similar change; nor was the LLC Act amended to eliminate its reference to the VSCA's demand requirements. The LLC Act's continued reference to the VSCA's now-amended shareholder demand requirements conflicts with its own apparent recognition of a demand-futility exception: the first sentence expressly limits a member's ability to bring derivative claims to those situations in which a stock corporation shareholder may do so - i.e., only after making demand - while the second sentence purports to permit a member to bring derivative claims without making demand if doing so would have been futile.<sup>8</sup>

The circumstances surrounding the LLC Act's inconsistency suggest that the General Assembly intended the LLC Act to mirror the VSCA but simply failed to amend the LLC Act to remove its demand-futility language. In the absence of legislative action, however, this uncertainty and its deterrent effects will persist, and it is unclear whether the Virginia courts can resolve the conflict in the LLC Act's language: it will be difficult for a court, employing canons of construction typically used to interpret ambiguous statutes, to discern the General Assembly's actual intent. On one hand, the LLC Act refers to the entire VSCA rather than a specific section, making its incorporation of the latter one of general reference, and when one statute incorporates another by general reference, any subsequent amendments to the incorporated statute—e.g., the subsequently enacted universal-demand requirement—also become part of the incorporating statute.<sup>9</sup> Thus, it could be reasoned that by incorporating the VSCA's restrictions for shareholder-derivative suits, the General Assembly intended the LLC Act to incorporate VSCA's restrictions even if they were subsequently amended. On the other hand, legislatures are presumed not to use surplus words, and to the extent possible, courts are to give meaning to all words in a statute.<sup>10</sup> Yet to interpret the LLC Act as incorporating the universal-demand requirement from the VSCA is to completely ignore the LLC Act's own language acknowledging a demand-futility exception, which suggests that the General Assembly did not intend the demand-futility exception to change even if the VSCA was later amended.<sup>11</sup>

The General Assembly can resolve this conflict and achieve consistency and predictability by amending the LLC Act to establish either that (a) the

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demand futility exception applies to LLCs, or (b) the universal demand rule applies to LLCs, as it does to corporations. Several reasons suggest, however, that a universal-demand requirement may be the preferable statutory rule. First, like the directors of a corporation, those managing an LLC should have an opportunity to control—at least initially—claims brought on its behalf. An LLC, like a corporation, is a legal entity separate and distinct from its members with authority to conduct business on its own behalf. In member-derivative suits, the LLC is the real party in interest, just as the corporation is the real party in interest in shareholder-derivative suits. The authority to manage an LLC's affairs is vested in all of the members (proportionately according to their contributions to the LLC) or the managers they appoint, not in any individual member.<sup>12</sup> Indeed, to encourage the exercise of this authority, an LLC's managers, like a corporation's directors, are entitled to a limitation on liability and the protection of the business judgment rule.<sup>14</sup> Second, the issues raised during demand-futility motions in member-derivative suits, like their counterparts in shareholder-derivative suits, are collateral to the merits of the underlying claims. Thus, eliminating those issues from a dispute streamlines the litigation and eliminates the unnecessary expenditure of resources associated with them.

Furthermore, several features of the LLC that could be perceived as unique actually parallel features of the corporation under Virginia law. The LLC Act allows members to allocate man-

agement responsibility for the LLC among members or non-member managers in the articles of organization or operating agreement,<sup>15</sup> possibly creating confusion as to the body on which a derivative plaintiff must make demand, but the VSCA also allows shareholders to eliminate the board of directors or restrict its authority by agreement.<sup>16</sup> And the LLC Act's flexibility does not necessarily create confusion because a derivative plaintiff must be a member and therefore would be privy to the articles of incorporation or operating agreement that allocated the relevant authority. Similarly, although any act by an LLC member or manager may be taken without a meeting,<sup>17</sup> creating possible concern that members or managers would give a demand short shrift, any act by a corporation's directors also may be taken without a meeting.<sup>18</sup>

Nonetheless, LLCs are not exactly like corporations. Unlike corporations, which are creatures of statute, LLCs are created by contract, and an LLC's members can opt-out of most rules contained in the LLC Act. But this flexibility apparently does not extend to pre-suit demand requirements: the LLC-demand statute does not include "unless otherwise provided in the articles of organization or operating agreement" or other similar language.<sup>19</sup> As a result, the pre-suit demand requirements (whatever they may be) currently appear to be mandatory for all Virginia LLCs. That the pre-suit demand requirements are mandatory is another reason to

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## Professional Announcements

**Catherine M. Reese, Esq.**, Council Member-elect to the Virginia State Bar, and of the Reese Law Office formerly known as The Law Office of Catherine M. Reese, PLC, along with her associates, Laurie M. Crawford and Katelin T. Moomau, are pleased to announce their relocation to **10300 Eaton Place, Suite 150, Fairfax, Virginia 22030**, where they will continue to offer a full array of personalized family law solutions through advocacy, mediation, collaboration and litigation.

**Douglas R. Burtch** has joined Macaulay & Burtch, P.C. after practicing law in Northern Virginia with Littler Mendelson and Pillsbury Winthrop Shaw Pittman. Burtch earned his bachelor's degree from Emory University in Atlanta and his law degree from the University of Richmond. He then clerked for the Supreme Court of Virginia. Burtch represents companies, executives and professionals in employment and labor issues.

## Open Positions

Lawyer wanted by patent law office. Must have JD or LL.M. Must have license to practice law in US. Must speak, read & write Korean. Send resume to WIAV Solutions, LLC, 8133 Leesburg Pike, Ste 640, Vienna, VA 22182.

## Pre-Suit Demand

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expressly codify either universal demand or demand futility in the LLC Act, but it also suggests an additional amendment that may be beneficial: the General Assembly could add language to the codified rule (whichever it selects) that permits members to opt-out if they believe the other rule better suits the LLC's needs. This additional amendment would harmonize pre-suit demand requirements with most other aspects of the LLC.

To summarize, the continuing uncertainty about the LLC Act's demand requirements could deter those who want to establish an LLC from doing so in Virginia. To solve this problem, the General Assembly should amend the LLC Act and clarify whether the universal-demand rule or the demand-futility exception applies to LLCs, and whether members may contract around whichever rule is codified. And while any clear and unambiguous amendment addressing these issues would remove the ongoing uncertainty, there do not appear to be significant reasons to have a universal demand rule for corporations and a different rule for LLCs. Thus, the General Assembly should consider amending the LLC Act to codify a universal-demand requirement and also to permit members to adopt a demand-futility exception in the articles of organization or operating agreement if they believe that exception better suits their particular situation. ■

### NOTES

- 1) *Simmons v. Miller*, 544 S.E.2d 666, 675 (Va. 2001).
- 2) The universal-demand requirement also has been enacted in at least 12 other states - Arizona, Connecticut, Georgia, Idaho, Maine, Michigan, Mississippi, Montana, Nebraska, New Hampshire, North Carolina, and Wyoming - as well as incorporated into the American Law Institute's and American Bar Association's respective model rules. See American Law Institute, *Principles of Corporate Governance: Analysis and Recommendations*, § 7.03 (1994); American Bar Association, Model Business Corporation Act, § 7.42 (3d ed.).
- 3) See Va. Code Ann. § 13.1-672.4.C (requiring court to dismiss complaint unless plaintiff "alleges with particularity facts establishing that" refusal was not made in good faith).
- 4) See *Abella v. Universal Leaf Tobacco Co.*, 495 F. Supp. 713, 717 (E.D. Va. 1980), modified on other grounds, 546 F. Supp. 795 (E.D. Va. 1982).
- 5) See, e.g., American Law Institute, *Principles of Corporate Governance: Analysis and Recommendations*, § 7.03, cmt. e (1994); American Bar Association, Model Business Corporation Act, § 7.42, cmt. 7-342 (3d ed.).
- 6) Va. Code Ann. § 13.1-1042.
- 7) Va. Code Ann. § 13.1-672.1.B.
- 8) In addition, the LLC Act requires a complaint to "set forth with particularity the effort of the plaintiff to secure commencement of the action by a member or manager with the authority to do so or the reasons for not making the effort." Va. Code Ann. § 13.1-1044.
- 9) See 2B Norman J. Singer, *Sutherland Statutes and Statutory Construction* § 51:7 (6th ed. 2007).
- 10) See *id.* § 47:37.
- 11) See *id.*
- 12) See Va. Code Ann. § 13.1-1009.
- 13) See Va. Code Ann. § 13.1-1022.A-C.
- 14) See Va. Code Ann. § 13.1-1024.1 & -1025 (LLC); Va. Code Ann. § 13.1-690.A & -692.1 (corporation).
- 15) Va. Code Ann. § 13.1-1024.
- 16) Va. Code Ann. § 13.1-671.1.A.1.
- 17) See Va. Code Ann. § 13.1-1022.E & -1024.I.
- 18) Va. Code Ann. § 13.1-685.
- 19) Va. Code Ann. § 13.1-1042.

## Calendar of VBA Events

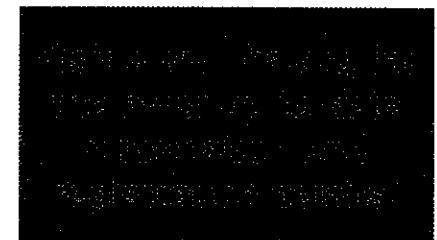
July 23-26, 2009  
Annual Summer Meeting  
The Homestead, Hot Springs

October 2-3, 2009  
37th Annual Conference on Labor & Employment Law  
Hilton Virginia Beach Oceanfront

October 9-11, 2009  
YLD Executive Committee Meeting  
Stonewall Jackson Hotel, Staunton

October 16-18, 2009  
Board of Governors Meeting  
Wintergreen Resort

January 21-24, 2010  
120th Annual Meeting  
Colonial Williamsburg



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