

Client Alert

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Virginia LLC Update: Supreme Court of Virginia Revives Demand Futility Exception in Derivative Actions by Members of LLCs

On May 31, 2018, the Supreme Court of Virginia issued an opinion holding that the Virginia Limited Liability Company Act (the VLLCA) does not require a member of a limited liability company to first make a demand on the LLC prior to commencing a derivative proceeding on behalf of the LLC if doing so would be futile. The court's interpretation of the derivative actions sections of the VLLCA in this case comes as a surprise to many Virginia law practitioners who since 2011 have interpreted the statute as requiring written demand prior to bringing a derivative claim in all cases. In *Davis v. MKR Development, LLC*,¹ the court concluded that, while the 2011 amendments to the statute deleted the express demand futility language, they did not abolish the futility exception altogether. Rather, the amendments effectively replaced a statutory demand futility exception with a common law one.

Background

The plaintiff, Dorothy Davis, was a member of Woodside Properties, LLC, a Virginia limited liability company. Davis filed a derivative complaint on behalf of Woodside Properties against its manager, MKR Development, LLC, as well as the managers of MKR Development. Davis alleged that MKR Development and its managers breached their fiduciary duties to Woodside Properties, wasted the assets of Woodside Properties and unjustly enriched themselves. Davis did not make demand on the defendants prior to filing her complaint "because such demand would have been a futile, wasteful, and useless act as they were the parties who authorized and ratified the alleged wrongful conduct complained of... and were the direct beneficiaries thereof, and [were] incapable of making an independent and disinterested decision to institute and vigorously prosecute this action."

The defendants filed a plea in bar and demurrer alleging that the complaint was barred because Davis did not make proper demand as required by the VLLCA. The circuit court agreed, dismissing the action without prejudice. The Supreme Court of Virginia agreed to review the decision on appeal.

Court's Decision

In analyzing whether the VLLCA requires universal demand prior to commencing a derivative action, or allows demand to be excused as futile, the court framed the issue as one of statutory construction. The court reviewed the history of the demand requirement and futility exception under Virginia law. The court began by discussing the development of the equitable futility exception in case law involving traditional corporations more than a century ago. The court explained that when the VLLCA was first enacted in 1991, the futility exception for LLCs was effectively codified in Section 13.1-1042. As originally adopted in 1991, the VLLCA provided in pertinent part that "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.*" The court noted that in 2011, Section 13.1-1042 was amended

¹ ___ S.E.2d ___, 2018 WL 2440199 (Va. 2018).

to delete the express futility exception from the statute and add language prohibiting members from commencing a derivative proceeding until written demand has been made on the LLC.

The court then addressed the defendants' argument that since the 2011 amendments to the VLLCA deleted the futility exception from Section 13.1-1042, the futility exception was effectively abolished, meaning that demand was required in all cases. The court identified two problems with the defendants' statutory interpretation.

First, the court noted that both before and after the 2011 amendments, the pleading requirements in Section 13.1-1044 of the VLLCA continued to state that "the complaint shall 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 reason for not making the effort.*" The court reasoned that a portion of this section of the VLLCA would be superfluous if a plaintiff was required to make a demand in all cases, and therefore was unable to plead the reason for *not* making a demand. The court applied the canon of statutory construction that every part of a statute should be given meaning, if possible, and concluded that the 2011 amendments to Section 13.1-1042 must not have been intended to require demand in all cases. Otherwise, a portion of Section 13.1-1044 would be rendered meaningless.

Second, the court noted that Section 13.1-1001.1(A) of the VLLCA provides that "the principles of law and equity supplement this chapter" except where "displaced by particular provisions." The court found that, since the text of Section 13.1-1042 does not expressly disclaim the futility exception, Section 13.1-1001.1(A) "embraces within its scope the futility exception, which has long been a part of our law." Reading these statutory provisions together, the court concluded that the Virginia General Assembly did not abolish the futility exception when it amended Section 13.1-1042 of the VLLCA in 2011. Rather, the amendments effectively replaced a statutory futility exception with a common law one. As a result, the circuit court erred in dismissing the plaintiff's complaint for not making a demand prior to commencing her derivative proceeding. The court reversed the circuit court's judgment and remanded it with instructions to reinstate the plaintiff's complaint.

Key Observations and Takeaways

The upshot of the *MKR Development* decision is that a member of a Virginia LLC may now commence a derivative proceeding on behalf of the LLC without first making demand on the LLC if the member alleges that making a demand would be futile. From a policy standpoint, one could debate whether the better rule is to require universal demand in all cases. Most states follow the majority rule of allowing a futility exception. Unlike the VLLCA, both the Delaware Limited Liability Company Act and the Uniform Limited Liability Company Act provide an express futility exception in their derivative action statutes. After *MKR Development*, a common law futility exception will apply to derivative actions involving Virginia LLCs, and it will be easier for members of Virginia LLCs to bring derivative actions by alleging that demand would be useless. Courts must now be prepared to wrestle with arguments over whether demand was futile under the particular facts and circumstances of each case.

Here are a few observations and takeaways after the *MKR Development* decision:

- ***Allowing the Futility Exception for LLC Derivative Suits is a Departure from Virginia Corporate Law's Universal Demand Requirement.*** The universal demand requirement has been a part of Virginia corporate law since the Virginia Stock Corporation Act (the VSCA) was amended in 1992 (the year after the VLLCA was first enacted). In a 2007 decision, *Firestone v. Wiley*,² a Virginia federal district court declared that a shareholder-plaintiff's claims "failed at the outset because it is undisputed that she did not make the statutorily-required written demand on the corporation." The court cited Section 13.1-672.1 of the VSCA, which became part of the

² 485 F.Supp.2d 694 (E.D. Va. 2007). *Firestone* is a federal district court case that is not binding on Virginia state courts.

statute in 1992, as requiring that written demand be made on a corporation as a condition precedent to the commencement by a shareholder of a derivative proceeding. The universal demand language in Section 13.1-672.1 of the VSCA tracks the language in Section 13.1-1042 of the VLLCA. However, the *MKR Development* court interpreted the language in the VLLCA differently than the *Firestone* court interpreted the language in the VSCA, in part due to other sections of the VLLCA not present in the VSCA.

- ***The Futility Exception to the Demand Requirement May Not Be Difficult for LLC Members to Prove.*** Virginia case law involving the question of whether demand should be excused as futile developed prior to the 1992 amendments to the VSCA that established the universal demand rule for corporations. Courts often focused on whether making demand on the corporation would be useless because the decision makers have a personal interest in the outcome. In the LLC context, many LLCs are closely held and do not have the ability to form special committees of disinterested members or managers to evaluate whether to bring a derivative claim. As a result, the futility exception could be used frequently in derivative actions involving LLCs.
- ***The VLLCA May Need to be Amended to Clarify the Demand Requirement.*** If the Virginia legislature intended to establish a universal demand requirement for derivative actions by members of LLCs when it amended the VLLCA in 2011, then the legislature should consider further amending the statute after the *MKR Development* decision. Specifically, the VLLCA could be amended by (i) adding language to Section 13.1-1042 that expressly abolishes the futility exception to the demand requirement and (ii) removing the language in Section 13.1-1044 that the *MKR Development* court found to imply a common law futility exception. These amendments would clarify that universal demand is a condition precedent to commencing any derivative action on behalf of a Virginia LLC.
- ***Principles of Law and Equity Supplement the VLLCA.*** *MKR Development* is a reminder to members and managers of Virginia LLCs that principles of law and equity are always lurking in the background and supplement the VLLCA unless they are displaced by particular provisions of the statute. The explicit incorporation of common law into corporate governance of LLCs could lead to some unexpected results.³ In a footnote in the *MKR Development* decision, the court was careful to note that, in holding that the 2011 amendments to Section 13.1-1042 of the VLLCA effectively replaced a statutory futility exception with a common law one, the court was not suggesting a general rule that “any time a statute is repealed, the repeal will invariably revive default principles developed through case law prior to the adoption of the statute.” Rather, the court’s holding was based on Section 13.1-1044 of the VLCCA, “which presupposes the continued existence of the futility exception,” as well as Section 13.1-1001.1(A), which incorporates principles of law and equity into the VLLCA. If Section 13.1-1044 did not include the futility language in question, consider whether the court would have come to the same conclusion relying on common law principles alone.

Sean P. Ducharme
sducharme@HuntonAK.com

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³ For example, in *In re Virginia Broadband, LLC*, 521 B.R. 539 (Bankr. W.D. Va. 2014), the court held that Virginia common law does not impose a fiduciary duty of loyalty upon a manager of a Virginia LLC.