

December 2014

Virginia LLC Update: Bankruptcy Court Refuses to Impose Fiduciary Duty of Loyalty on a Manager of a Virginia LLC

Sean P. Ducharme
Hunton & Williams LLP
(804) 788-8398
sducharme@hunton.com

On November 5, 2014, the United States Bankruptcy Court for the Western District of Virginia issued a noteworthy opinion that runs counter to what many Virginia law practitioners assume to be the common law in Virginia – *i.e.*, that a manager of a Virginia limited liability company owes a fiduciary duty of loyalty to the limited liability company. In the case, *In re Virginia Broadband, LLC*,¹ the court refused to impose a duty of loyalty upon a manager of an LLC because the court concluded that no such duty existed under statutory or common law or the LLC’s operating agreement.

Background

In re Virginia Broadband, LLC was a Chapter 11 bankruptcy case involving a manager-managed Virginia limited liability company, Virginia Broadband, LLC. The LLC was a debtor in possession. For many years, the members of the LLC clashed over fundamental matters including management control, ownership and remuneration. Warren Manuel, a former member and manager of the LLC, had loaned money to the LLC on an unsecured basis while he was a member and manager. Mr. Manuel filed proofs of claim in the bankruptcy as an unsecured creditor to recover such amounts. The LLC asked the court to disallow or equitably subordinate Mr. Manuel’s claims, or recharacterize them as equity, because Mr. Manuel breached his fiduciary duties to the LLC. The court denied the LLC’s requests.

Court’s Decision

The court examined Mr. Manuel’s fiduciary duties to the LLC as part of its consideration of the LLC’s request to equitably subordinate Mr. Manuel’s claims. The court explained that, if Mr. Manuel engaged in “inequitable conduct” that caused harm to creditors, a bankruptcy court could impose equitable subordination as a remedy under the Bankruptcy Code to offset the harm to the creditors. A breach by Mr. Manuel of his fiduciary duties would constitute inequitable conduct.

The LLC asserted that Mr. Manuel repeatedly breached his fiduciary duties by self-dealing (a breach of his duty of loyalty) and mismanagement of the LLC (a breach of his duty of care). The LLC alleged that Mr. Manuel breached his duty of loyalty by self-dealing when he issued an unsecured promissory note to the LLC and by paying himself excessive compensation. The LLC further alleged that Mr. Manuel breached his duty of care by failing to pay personal property taxes, obtain an audit or respond to business mail on behalf of the LLC.

¹ *In re Virginia Broadband, LLC*, No. 12-62535, 2014 BL 313170 (Bankr. W.D. Va. Nov. 5, 2014).

The court first noted that, under the terms of the operating agreement, the LLC was manager-managed. The court then examined the fiduciary duties of managers of Virginia LLCs and compared them to fiduciary duties of directors of Virginia corporations.

- **Duty of Loyalty.** The court stated that directors of a Virginia corporation owe a duty of loyalty to the corporation and its shareholders, citing *WLR Foods, Inc. v. Tyson Foods, Inc.*² The court also stated that although the Virginia Stock Corporation Act (the “VSCA”) “does not expressly state that a director of a corporation has the duty of loyalty, it does require that directors avoid conflict of interest,” citing Section 13.1-691 of the VSCA.³ By contrast, the court noted that the Virginia Limited Liability Company Act (the “VLLCA”) did not have a comparable statutory provision and that Virginia common law did not appear to impose a duty of loyalty on managers of an LLC. The court further noted that the LLC’s operating agreement did not expressly impose a duty of loyalty on the LLC’s managers. As a result, the court ruled that Mr. Manuel was not subject to any fiduciary duty of loyalty because the court could not find that such a duty existed. In dicta, the court noted that, even if it were to find that a duty to refrain from self-dealing existed, it was not persuaded that Mr. Manuel had breached that duty based on the LLC’s specific allegations.
- **Duty of Care.** The court noted that Section 13.1-1024A of the VLLCA imposes a general duty of care on managers of Virginia LLCs that is consistent with the duty of care imposed on directors of Virginia corporations set forth in Section 13.1-690A of the VSCA. Under of the VLLCA, a manager must discharge his or her duties as a manager in accordance with such person’s “good faith business judgment of the best interests of the limited liability company.” The court noted that the LLC’s operating agreement included a clause under the caption “Duties of Managers” which provided that the managers shall devote such time, effort and skill to the LLC’s business affairs as they deem necessary and proper for the LLC’s welfare and success. The court explained that the statutory standard of conduct is a subjective one that is not measured against the objective standard of what a reasonable person would do in similar circumstances. The court noted that, under the VLLCA, a person alleging a violation of the duty of care has the burden of proving the violation. The court concluded that the LLC did not meet its burden of proving that Mr. Manuel did not have a subjective good faith business judgment belief that his actions were in the best interests of the LLC.
- **Other Duties.** The LLC argued that Mr. Manuel breached his fiduciary duty “to ensure the best return to the creditors,” but the court concluded that the LLC failed to provide any evidence or support for the fact that such a fiduciary duty exists. In a footnote, the court stated that it construed the LLC’s argument as an attempt to apply the theory of “deepening insolvency” as a basis to equitably subordinate Mr. Manuel’s claims.⁴ The

² *WLR Foods, Inc. V. Tyson Foods, Inc.*, 869 F. Supp. 419 (W.D. Va. 1994).

³ Section 13.1-691 of the VSCA does not provide that directors must avoid conflict of interest transactions. Rather, Section 13.1-691 is merely a validating statute that provides that, if the terms of the statute are met, a conflict of interest transaction is not voidable solely because of a director’s interests in the transaction.

⁴ “Deepening insolvency” is a developing theory of law that provides an independent cause of action or grounds for damages by which a bankrupt company may recover against professionals, directors and officers who facilitated the company’s financial mismanagement.

court explained that no Virginia court has recognized the theory of deepening insolvency as a tort.

Key Observations and Takeaways

In re Virginia Broadband, LLC is a federal bankruptcy court decision that is not binding on Virginia state courts. The case may be viewed as one that was fact-specific, or an aberration with limited precedential or persuasive value, but only time will tell. In the meantime, here are a few key observations and takeaways:

- ***Virginia Law on Fiduciary Duties of Managers is Unsettled.*** *In re Virginia Broadband, LLC* shows that Virginia law on the fiduciary duties of managers of LLCs is not completely settled.
 - The VLLCA provides a statutory standard of conduct for managers and requires that they discharge their duties in accordance with their good faith business judgment of the best interests of the LLC. However, the VLLCA does not otherwise state what duties are owed by managers.
 - The Supreme Court of Virginia has (i) analogized the statutory standard of conduct applicable to a manager of an LLC to the statutory standard of conduct applicable to a director of a corporation,⁵ (ii) confirmed that a manager of an LLC owes fiduciary duties to the LLC, and not its members,⁶ and (iii) stated that whether an act constitutes a breach of a manager's fiduciary duty will depend on the circumstances of each case.⁷
 - However, the Supreme Court of Virginia has not ruled on whether any specific fiduciary duties are owed by managers under common law.
 - Many Virginia law practitioners have assumed that a manager of a Virginia LLC owes default common law fiduciary duties of care and loyalty to the LLC. This assumption is based largely on analogous corporate law since the statutory standard of conduct for managers of LLCs and directors of corporations is the same. In the context of directors of Virginia corporations, the Supreme Court of Virginia has held that the VSCA's statutory standard of conduct does not abrogate common law fiduciary duties and has recognized the common law duty of loyalty.⁸ Section 13.1-691 of the VSCA, which has no counterpart in the VLLCA, has not been viewed as creating the duty of loyalty.
- ***Fiduciary Duties Should be Defined in Operating Agreement.*** In light of the *In re Virginia Broadband, LLC* decision, members who want more certainty on the fiduciary duties of managers should consider including provisions in the LLC's operating

⁵ *Flippo v. CSC Associates III, L.L.C.*, 262 Va. 48, 56-57, 547 S.E.2d 216, 221 (2001).

⁶ *Remora Investments, L.L.C. v. Orr*, 277 Va. 316, 324, 673 S.E.2d 845, 849 (2009).

⁷ *Gowin v. Granite Depot, LLC*, 272 Va. 246, 258, 634 S.E.2d 714, 722 (2006).

⁸ *See Simmons v. Miller*, 261 Va. 561, 577; 544 S.E.2d 666, 676 (2001) (citing *Willard v. Moneta Building Supply, Inc.*, 258 Va. 140, 515 S.E.2d 277 (1999)).

agreement explicitly providing for and defining the fiduciary duties applicable to managers. For example, the operating agreement could provide that managers owe the same fiduciary duties to the LLC that directors owe to a corporation. Alternatively, members may already be comfortable that the statutory standard of conduct covers the duty of care, and instead the operating agreement could simply provide that managers owe a fiduciary duty of loyalty to the LLC. In addition, contracting parties could replicate the approval processes for conflict of interest transactions set forth in Section 13.1-691 of the VSCA or adopt other governance procedures in their operating agreements to regulate conflict of interest transactions.

- ***Statutory Standard of Conduct May Not be Modifiable in Operating Agreement.***
Whether an operating agreement can modify or eliminate a manager’s statutory standard of conduct is an open question under Virginia law. Section 13.1-1023A.1 of the VLLCA provides that an operating agreement may contain provisions that “are not inconsistent with” Virginia law or the LLC’s articles of organization. By its terms, the statutory standard of care in Section 1024.1.A is not a “default” provision because it does not expressly provide that it may be modified in an LLC’s articles of organization or operating agreement. As a result, a Virginia court may conclude that an operating agreement provision that modifies the statutory standard is inconsistent with the VLLCA and that such a provision is not enforceable.⁹ It stands to reason that an operating agreement provision that supplements the statutory standard of care with additional duties, rather than pares back or eliminates the statutory standard, would be less likely to be construed as inconsistent with the VLLCA and therefore more likely to be held enforceable by a Virginia court.
- ***Managers Do Not Owe Duties to Members and May Not Owe Duties to Creditors.***
Under Virginia law, managers do not owe fiduciary duties to members and may not owe fiduciary duties to creditors.¹⁰ This means that members do not, and creditors may not, have direct causes of action against a manager for breach of fiduciary duties. Under the VLLCA, a member may make a derivative claim against a manager on behalf of the LLC for breach of fiduciary duties, but a creditor may not. If members or creditors desire to bring direct claims against a manager for breach of fiduciary duties, then the operating agreement should expressly provide that managers owe fiduciary duties directly to the members or creditors.¹¹

⁹ See *Ott v. Monroe*, 282 Va. 403, 410-411, 719 S.E.2d 309, 312-313 (2011) (holding that a certain provision of the VLLCA could not be modified in an LLC’s articles of organization or operating agreement because the statutory provision was not qualified by the words “unless otherwise provided in the articles of organization or operating agreement”).

¹⁰ See *Remora*, *supra* note 6 (holding that the trial court did not err in dismissing a member’s direct claim against a manager of an LLC because a manager does not owe fiduciary duties to a member); *Luria v. Board of Dirs.*, 277 Va. 359, 672 S.E.2d 837 (2009) (assuming, without deciding, that a managing member of an LLC may owe a fiduciary duty to a third party creditor under certain circumstances).

¹¹ Va. Code § 13.1-1023A.1 provides that an operating agreement may provide rights to any person, including a person who is not a party to the operating agreement. The operating agreement could provide that a manager owes a creditor fiduciary duties, and the creditor could be an express third party beneficiary of such provision.

- ***Exculpation and Indemnification Provisions in Operating Agreement are Important.*** Careful consideration should be given to exculpation and indemnification provisions in an LLC's organizational documents. Regardless of what fiduciary duties are owed by a manager, the articles of organization or operating agreement of an LLC may limit or eliminate monetary damages assessed against a manager, except in the case of a manager's willful misconduct or a knowing violation of the criminal law.¹² An LLC also has the statutory power to indemnify a manager from claims and advance expenses to the manager, in each case subject to any standards and restrictions set forth in the LLC's articles of organization or operating agreement.¹³ There are no statutory limits on an LLC's ability to indemnify or advance expenses to a manager, even in cases of willful misconduct or a knowing violation of the criminal law.
- ***VLLCA May Need to be Amended to Clarify Fiduciary Duties of Managers.*** The Virginia legislature may need to consider amending the VLLCA to clarify what fiduciary duties are owed by managers of LLCs and whether members can modify or eliminate the statutory standard of conduct in an LLC's operating agreement.¹⁴ Although the VLLCA was enacted more than 23 years ago, the Supreme Court of Virginia has issued only a handful of opinions addressing fiduciary duties of managers of LLCs. By amending the VLLCA, the Virginia legislature could: (i) lower transaction costs by providing more certainty and predictability when determining what fiduciary duties apply to managers of LLCs and (ii) promote the VLLCA's stated policy of giving maximum effect to the principle of freedom of contract by providing more flexibility to members of LLCs to define what fiduciary duties, if any, they want to apply to managers.

¹² Va. Code § 13.1-1025.

¹³ VA. Code § 13.1-1009(16).

¹⁴ Delaware amended its Limited Liability Company Act effective August 1, 2013 to clarify that managers of limited liability companies have default common law fiduciary duties.