

Directors' and Managers' Ability to Limit or Exclude Liability

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The following is a brief comparison of the ability of corporate directors and LLC managers to exclude fiduciary duties and to limit liability for violating those duties under Virginia and Delaware corporate and LLC law.

VIRGINIA

Corporations

As fiduciaries, directors of Virginia corporations owe common law and statutory duties to the corporation and its shareholders.¹ See Va. Code Ann. § 13.1-690(A) (2012) (duties run to corporation), *Glass v. Glass*, 228 Va. 39, 47, 321 S.E.2d 69, 71 (1984) (duties run to shareholders). “A director shall discharge his duties as a director, including his duties as a member of a committee, in accordance with his good faith business judgment of the best interests of the corporation.” Va. Code Ann. § 13.1-690. Under Virginia law, alleged violations of a director’s duties are subject to the Business Judgment Rule (“BJR”), and the BRJ is protective of directors’ actions. *Willard v. Moneta Building Supply, Inc.*, 258 Va. 140, 151, 515 S.E.2d 277, 284 (1999) (“Code § 13.1-690(A) does not abrogate the common law duties of a director. It does, however, set the standard by which a director is to discharge those duties.”); see *WLR Foods, Inc. v. Tyson Foods, Inc.*, 869 F. Supp. 419, 424 (W.D. Va. 1994) (“That the [Virginia] Business Judgment Statute, for example, may appear to offer more protection for directors than do most or all analogous statutes in other states does not alter its plain language.”). Therefore, when judging whether a director has violated any particular duty in the first place, it is done against a deferential standard.

If the BJR were not deferential enough, Virginia Code § 13.1-692.1 also allows for the elimination of director (and officer) liability for breaches of duty, as long as it is set forth in the Articles of Incorporation or bylaws. See also *In re LandAmerica Financial Group, Inc. v. Alpert*, 470 B.R. 759 (Bankr. E.D. Va. 2012) (“The Virginia Stock Corporation Act permits the elimination of liability of directors and officers if such a limitation is set forth in a corporation’s articles of incorporation . . .”). Further, the statute automatically caps personal liability of directors and officers to the greater of \$100,000.00 or the amount of the director’s last year’s salary. Va. Code Ann. § 13.1-692.1(A)(2). However, notwithstanding the fact that Virginia law provides directors the benefit of the BJR, automatically caps personal liability of officers and directors, and allows a corporation to further contract around and limit or entirely eliminate liability for breach of a duty owed by a director of a corporation, the Virginia Stock Corporation Act prohibits parties from limiting or eliminating liability of directors and officers for actions that constitute willful misconduct or knowing violations of criminal or securities law. See Va. Code Ann. § 13.1-692.1(B).

Limited Liability Companies

The Virginia statutes regarding duties and the alteration thereof in LLCs are substantially the same as the Virginia corporate statutes, and courts often look to corporate cases in analyzing these duties in the LLC context. See *Flippo, et al. v. CSC Assocs. III, LLC*, 262 Va. 48, 547 S.E.2d 216 (2001). The BJR applies to the determination of whether a manager of an LLC has breached a duty, Va. Code Ann. §13.1-1024.1(A), and liability for alleged breaches, other than willful misconduct or violations of criminal law, can be limited or entirely eliminated by contract (within the Articles of Organization or an operating agreement), Va. Code Ann. § 13.1-1025. Virginia LLCs also enjoy the automatic cap on personal liability of LLC managers for breach of duty to the greater of \$100,000.00 or the manager’s

¹ Common law fiduciary duties are the duty of loyalty and the duty of care. *Colgate v. Disthene Group, Inc.*, 2012 Va. Cir. LEXIS 67, *15 (Va. Cir. Ct. Aug. 30, 2012) (“A director’s duties, such as the duty of care and the duty of loyalty are found in the common law.”).

last year's salary. *Id.* Like corporations, LLCs organized under Virginia law have a great deal of freedom to contract and tailor the duties owed by a manager to the LLCs needs.

DELAWARE

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As in Virginia, general fiduciary duties of Delaware corporate directors are created by common law rather than statute. Unlike Virginia, however, Delaware limits the duties that can be restricted and or eliminated. Under § 102(b)(7) of the Delaware General Corporate Laws, a Certificate of Incorporation may contain provisions:

eliminating or limiting the personal liability of a director to the corporation or its stockholders for monetary damages for breach of fiduciary duty as a director, provided that such provision shall not eliminate or limit the liability of a director : (i) For any breach of the director's duty of loyalty to the corporation or its stockholders; (ii) for acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law; (iii) under § 174 of this title; or (iv) for any transaction from which the director derived an improper personal benefit . . .

6 Del. Code Ann. §102(b)(7) (2012). The result is that under Delaware law, only a director's liability for the duty of care can be altered or eliminated by including a § 102(b)(7) clause in the Certificate of Incorporation.

Delaware courts also have adopted the BJR as the means by which alleged breaches of fiduciary duties are to be judged. *See In re Walt Disney Co. Derivative Litigation*, 825 A.2d 275, 286 (Del. Ch. Ct. May 28, 2003). However, Delaware courts have molded the BJR to create a less deferential standard in certain scenarios. For example, if a majority of directors (or just one controlling director) have a financial interest in the contested action, the standard against which the directors' actions are judged is "entire fairness." *Telxon Corp. v. Meyerson*, 802 A.2d 257, 264 (Del. 2002). This standard looks to ensure both fair dealing and fair price. *Weinberger v. UOP, Inc.*, 457 A.2d 701, 711 (Del. 1983) (Fair dealing "embraces questions of when the transaction was timed, how it was initiated, structured, negotiated, disclosed to the directors, and how the approvals of the directors and the stockholders were obtained." Fair price "relates to the economic and financial considerations of the [transaction], including all relevant factors: assets, market value, earnings, future prospects, and any other elements that affect the intrinsic or inherent value of a company's stock."). Additionally, the BJR is not used to review a director's choice of purchaser in the event of a sale of substantially all of the shares or assets of the corporation. Under Delaware law, a director is required to maximize shareholder profit, *i.e.*, often to sell for the highest price. *Revlon, Inc. v. MacAndrews & Forbes Holding, Inc.*, 506 A.2d 173, 182 (Del. 1986).

Limited Liability Companies

Delaware LLCs have much more freedom to alter duties than do Delaware corporations. A Delaware LLC can not only limit or eliminate a manager's liability for breach of duty, but the code specifically allows for the LLC agreement to eliminate or limit the *duties* that exist in the first place (other than the implied duty of good faith and fair dealing). *See* 6 Del. Code Ann. § 18-1101, *Fisk Ventures, LLC v. Johnson et al.*, 2008 Del. Ch. LEXIS 158, *41-*42(Del. Ch. Ct. May 7, 2008) ("[The] Agreement eliminates fiduciary duties to the maximum extent permitted by law by flatly stating that members have no duties other than those expressly articulated in the Agreement. Because the Agreement does not expressly articulate fiduciary obligations, they are eliminated."). A recent decision has made clear that, by default, an LLC manger owes all common law fiduciary duties, provided that these duties or liability therefore are not limited or eliminated in the LLC operating agreement. *Auriga Capital Corp. v. Rooney*, 40 A.3d 839 (Del. Ch. 2012). Although not entirely established, *Wood v. Baum*, suggests that the BJR applies to Delaware LLCs. *Wood v. Baum et al.*, 953 A.2d 136, 141 (Del. 2008) (discussing whether the management of an LLC properly exercised its business judgment). Given the flexibility of an LLC to expand, limit, or eliminate duties before a breach and the ability to expand, limit, or eliminate liability after such a breach, it is likely that the BJR would only apply to a Delaware LLC if duties and liabilities were not addressed in the operating agreement.

COMPARISON

Corporations

Virginia law clearly affords corporate directors more protection than Delaware law. Under Delaware code, only the fiduciary duty of care can be limited or eliminated by election; whereas, the language of the Virginia code provides that all duties (fiduciary or otherwise) can be limited or eliminated by election in the Articles of Incorporation or bylaws. Furthermore, even if director duties are not altered in the Articles of Incorporation, Virginia law caps personal liability for breach to the greater of \$100,000 or the previous year's salary. Under Delaware law, this limitation would have to be elected in the Certificate of Incorporation, and it would only be valid for liability for breach of the duty of care. Finally, although both States recognize and adopt the BJR, Delaware's case law has created certain variations on the standard that decrease the deference toward a director's business judgment. Virginia law has not made such variations, perhaps because the BJR under Virginia law arises by statute rather than case law. See *Willard* 258 Va. at 151, 515 S.E.2d at 284 (rejecting the heightened *Revlon* test from Delaware and stating that it is up to the legislature to create a different standard).

Limited Liability Companies

Both Virginia and Delaware have very manager-friendly statutes concerning the operation of an LLC and allow for great flexibility in deciding the rights and liabilities of the management. However, Delaware law allows for the limitation or elimination of personal liability of managers as well as the elimination of all duties (other than the duty of good faith and fair dealing). Virginia, on the other hand, only allows the limitation or elimination of personal liability of managers. While Delaware's laws may sound more beneficial, from a manager's stand-point, there can hardly be a difference between eliminating the duty and eliminating liability for not exercising the duty. Whether one or both are implemented, the result is the same for the manager—no liability.

The caveat to Delaware's ability to alter management's duties is that the LLC operating agreement cannot alter or eliminate the duty of good faith and a manager's actions cannot be exculpated if they constitute a bad faith violation of the duty of good faith and fair dealing, whereas the caveat to Virginia's statute is that willful misconduct and knowing violations of criminal law cannot be exculpated. Practically, these exceptions are nearly the same and likely cover the same conduct.

Delaware and Virginia statutes differ in their default terms. Under Virginia law, if nothing is provided in the operating agreement to alter or limit the BJR, the BJR applies to determine whether there has been a breach of a duty. It is unclear under Delaware law whether the BJR applies if duties and liability is not addressed in the Operating Agreement, and, if so, how it applies. If it applies in the same way as it does in Delaware corporate law (as it likely would), then Virginia's BJR provides greater protection where the operating agreement is silent as to the managers duties. More significantly though, under Virginia law, even if no liabilities are altered in the operating agreement, Virginia law caps personal liability at \$100,000 or last year's salary as it does for corporate directors. While this can be expanded or restricted by contract, that is the default rule in Virginia. Under Delaware law, if neither duties nor liability are limited or eliminated in the operating agreement, the default rule is that all common law fiduciary duties exist and there is no cap on liability. Because of the default provisions in the Virginia code and the fact that the application of both states' LLC Acts are virtually the same in all other respects, Virginia would seem to be more manager-friendly than Delaware, unless the duties and liabilities of managers are eliminated or limited in the operating agreement.