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CORPORATE DECISION-MAKING AND DISPUTES: A BASIC GUIDE TO GOOD GOVERNANCE PRINCIPLES

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Members of the George Mason Inn of Court pursue varied practice areas. For those who pursue litigation, domestic relations, commercial law and corporate law, it is common to encounter clients who own corporations, or serve as officers or directors, and who are involved in some form of transaction or dispute. The following hypotheticals are typical situations:

1. Your sorority sister from college, who just cashed out of a lucrative closely-held tech company, is suddenly receiving invitations to join boards of directors. In her start-up, things were run informally until the very end, and thus she comes to you because she wants to understand what duties and responsibilities she may assume by agreeing to serve on the board.

2. A cold-call comes into the firm from a minority stockholder who believes that the directors have completely abandoned any concern for any stockholders other than the founder of the company, who owns preferred and common stock. The caller says the founder pays himself excessive compensation and benefits, pays dividends that appear greatly discounted based on available cashflow, and has not held an annual meeting in 4 years. The caller wants to seek dissolution.

3. A company obtained venture capital ("VC") to support a growth strategy that could lead to an initial public offering. The VC firms received preferred stock containing liquidation preferences and placed representatives on the board of directors (the "Board"). Although the Company increased revenue year-over-year and eked out a small and slowly growing profit, it failed to satisfy its VC backers. After 4 years, the VC directors began looking to exit. As part of the "exit" process, the VC-dominated Board adopted a management incentive plan (the "MIP") that incented officers and key employees to remain with the company through a sale process, but which was structured so that it compensated management for achieving a sale even if the transaction yielded nothing for the common stockholders. An offer to purchase the company for cash and stock was received which entitled the VC investors to their liquidation preference but which, after the MIP payout, would leave nothing for the common stockholders. Your client is an independent board member and wants to know what to do before voting.

4. The CEO and Chairman of the Board of a local business owns 51% of a lucrative government contracting firm. Her husband, who just filed for divorce, owns the other 49%. The CEO is responsible for bringing in all the business, and threatens to start a competing business if her husband will not sell her his shares at a 20% discount to Fair Market Value. The CEO's husband comes to you for advice on how to respond.

Whether the issues concern those such as the hypotheticals mentioned above, or otherwise, all of the questions invariably invoke questions about the board of directors, and understanding the dynamics of how directors should make decisions is elemental.

The following discussion is a basic primer of the duties of a board of directors under Delaware and Virginia law. It may not be relied upon as legal advice.

A Very, Very, Very Brief History Of The Corporate Idea In America

Corporations have been around a long time, and in North America they have a particular connection to Virginia. The first English settlers in the New World established a colony in Jamestown, Virginia, in 1607 and were backed by an early form of private equity. The company formed for the purpose was called The London Company (*aka* The Virginia Company of London). This enterprise was enabled by investment from wealthy patrons and James I, King of England. The King granted the Company a "charter" entitling it to establish a colony extending from Cape Fear (in North Carolina) up to the Long Island Sound. Funds raised to launch the enterprise were lured, in large measure, by the hope that the colonists would find gold, silver and other treasure.

Corporations are considered to be their own entities by the law. That is to say, they have a separate existence apart from their constituents, the latter being "stockholders" in for-profit corporations. The *raison d'etre* of corporations is to permit investors to contribute capital or services without exposing themselves to personal liability. The promise of "limited liability" promotes risk-taking activity, within reason, and risk-taking has been at the heart of Anglo-American capitalism since its earliest incarnations in roughly the 17th century.

Before modern regulation became pervasive, policy makers in the organized bars of Great Britain and America needed a way for corporations to self-regulate in order to continue to promote investment, risk-taking and the hoped-for byproduct of those goals: general economic prosperity for individual corporations and society at large. Smart lawyers and legislators looked to something with ancient roots in Anglo-American law: the law of trusts. Under the law of trusts, persons who are "entrusted" with the funds or property of others owe those persons various duties, the most profound of which are called "fiduciary duties." It has been long established that corporations are run by a form of "trustee" the law calls a "director."

For a long time in the United States, the law of corporations was a relatively local matter. This made interstate trade more onerous, because potentially conflicting laws and regulations meant inefficiency. In turn, this inefficiency meant less investment and less risk-taking activity. In fact, before legislation was passed to permit anyone to incorporate by filing articles of incorporation with a centralized state registry, forming a corporation required a special act of the state legislature.

In the late 19th century, New York became a leading state in the development of corporate law, followed by New Jersey and then Delaware. Bright legal minds in Delaware soon realized that a careful restatement of the state's corporate law, to promote uniformity and therefore predictability, might be an economic boon for the state if it attracted incorporation from diverse interests and, at the same time, resulted in higher fees and tax revenue. The success of this idea is reflected in the lack of a state sales tax, as fans of Rehoboth and Bethany beaches will know.

To further cement the goals of uniformity and predictability, Delaware created jurisdiction to hear corporate disputes in an intermediate-level court called the Court of

Chancery. The thought was to have a bench that was expert in corporate law and sophisticated economic concepts, and that brought such expertise to bear on corporate questions on a consistent, relatively uniform basis under the Delaware General Corporate Law, or DGCL. The idea was a success, and today over 50% of publicly traded U.S. companies, and over 60% of Fortune 500 companies, are incorporated in Delaware. It is also commonplace for private equity investors and venture capitalists to insist that their investments be made into Delaware entities. This is because the rules of the road are generally well-established due to the DGCL and related decisions of the Court of Chancery. Less uncertainty equals less risk, which in turn increases the likelihood of intended outcomes.

Because of the relatively pervasive influence of Delaware law on American corporate life generally, it is important for Virginia corporate practitioners to understand Delaware law. Virginia has its own modern corporate statutes, but (perhaps unsurprisingly) there is only a tiny fraction of the case law that exists in Virginia. Thus, no discussion of Virginia corporate law would be complete without some reference to the law of Delaware, which often provides a background for issues of first impression in Virginia.[1]

In Virginia And Delaware, The Center Of Everything Corporate Is The Board Of Directors

In Virginia and Delaware, a foundational principle of corporate law is that "[t]he business and affairs of every corporation . . . shall be managed by or under the direction of a board of directors." 8 *Del. C.* § 141(a); Va. Code 13.1-683(B). When exercising their statutory responsibility, the standard of conduct requires that directors seek "to promote the value of the corporation for the benefit of its stockholders." *eBay Domestic Hldgs., Inc. v. Newmark,* 16 A.3d 1, 34 (Del.Ch.2010); *accord N. Am. Catholic Educ. Programming Found., Inc. v. Gheewalla,* 930 A.2d 92, 101 (Del.2007) ("The directors of Delaware corporations have the legal responsibility to manage the business of a corporation for the benefit of its shareholder[ ] owners."); *Unocal Corp. v. Mesa Petroleum Co.,* 493 A.2d 946, 955 (Del.1985) (citing "the basic principle that corporate directors have a fiduciary duty to act in the best interests of the corporation's stockholders"). This duty harkens back to the very early concept of directors as a form of trustee, an idea that undoubtedly has roots in late-night debates within the English Inns of Court and their later American counterparts, alongside actual cases and court arguments. *See, e.g., Giannoti v. Hamway,* 239 Va. 14, 24, 387 S.E.2d 725, 731 (1990).

As a basic principle, directors who do not understand their roles and duties are asking for problems, which in real life means can mean litigation and embarrassment. *In re Trados*

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[1] Of possible interest to Virginia lawyers, the modern incarnation of the DGCL has been significantly impacted by a Virginian named Ernest Folk. Folk was a man of vision who transcended his life in a wheelchair to become a law Professor at U.Va., and as an official Reporter he was one of the architects of the 1967 revision to the DGCL. He became the author of the famous treatise, *Folk on The Delaware General Corporation Law*, and some of his students and colleagues at U.Va. have been instrumental in modernizing the Virginia Stock Corporation Act found at Va. Code §13.1-601 *et. seq.*

Shareholder Litig., 73 A.3d 17, 62 (Del. Ch. 2013) ("*Trados II*") ("a director's failure to understand the nature of his duties can be evidence of unfairness"); *In re Trans World Airlines, Inc. S'holders Litig.*, 1988 WL 111271, at *5 (1988) (Allen, C.) (observing that special negotiating committee members who believed their only obligation was to determine fairness and not to maximize value for the common stock had an "imperfect appreciation of the proper scope and purpose of such a special committee").

In the world of for-profit, solvent corporations, and as discussed later in this publication, directors must put themselves in a position make informed decisions that promote and enhance the value of the corporation for its investors. This is effectively a "golden rule" of corporate management, the breach of which is generally the root of all litigation and controversy. In practice, a rational decision that enhances overall stockholder value, without favoritism, will almost never be open to question absent other, perhaps surprising, facts.

On the other end of the spectrum, buying an expensive corporate jet when it is not needed, or pervasively making questionably low dividend payments while simultaneously overcompensating certain key officers, could involve prohibited acts of self-dealing or breaches of fiduciary duty unless there were solid, articulable reasons for the conduct that rationally relate to increasing shareholder value.

In the middle are other types of decisions and expenditures, such as corporate spending on charity or sponsoring a minor league baseball team (which may not seem to enhance shareholder value). However, "it is, of course, accepted that a corporation may take steps, such as giving charitable contributions or paying higher wages, that do not maximize profits currently. They may do so, however, because such activities are rationalized as producing greater profits over the long-term." Leo E. Strine, Jr., *Our Continuing Struggle with the Idea that For–Profit Corporations Seek Profit,* 47 Wake Forest L.Rev. 135, 147 n. 34 (2012).[2]

The question in each and every one of these cases is whether there is a sufficient, good faith nexus between the corporate act and its benefit to the corporation and its residual claimants (*i.e.*, the stockholders, though in an insolvent corporation creditors could become the residual claimants). This is the lens through which directors, at their most basic level, must view every act and decision they pass upon. The more attenuated the action looks against the backdrop of shareholder value, the more care that must be paid to (a) the potential decision under consideration and (b) the process by which the decision is to be made. This is almost always a case-by-case situation. Notably, courts tend to care a great deal about *process* as much as the result, because a ramshackle or less-than-diligent process is often predictive of bad faith or grossly inappropriate decisions. *See, e.g., Kahn v. Tremont Corp.*, 694 A.2d 422, 432 (Del.1997) ("[H]ere, the process is so intertwined with price that under [a] unitary standard a finding that the price negotiated by the Special Committee might have been fair does not save the result.")

The foregoing discuss illustrates why judicial opinions often say that directors owe fiduciary duties "to the corporation and its shareholders." *North American Catholic Educational*

[2] Leo E. Strine, Jr. is currently the Chief Justice of the Delaware Supreme Court.

Programming, Inc. v. Gheewalla et al., 930 A.2d 92, 99 (2007). These duties are the duty of care, and the duty of loyalty. *Mills Acq. Co. v. Macmillan, Inc.*, 559 A.2d 1261, 1280 (Del.1989) ("[D]irectors owe fiduciary duties of care and loyalty to the corporation and its shareholders ...."); *Polk v. Good,* 507 A.2d 531, 536 (Del.1986) ("In performing their duties the directors owe fundamental fiduciary duties of loyalty and care to the corporation and its shareholders."). The duty of care involves the duty to be reasonably informed about the corporation and any decisions that need to be made. *See, e.g., McMullin v. Beran*, 765 A.2d 910, 921 (Del. Ch. 2000) ("a director's duty to exercise an informed business judgment implicates the duty of care"). The duty of loyalty involves the duty to seek only that which is best for the corporation, not what is best for the director herself, or for a particular constituency of stockholders or stakeholders. *See In re Orchard Enterprises, Inc. Stockholders Litig.*, 88 A.3d 1, 38 (Del. Ch. 2014); *Strassburger v. Earley,* 752 A.2d 557, 581 (Del.Ch.2000). The duty of care can be waived in a Charter or Articles of Incorporation. 8 Del. C. § 102(b)(7); *see* Va. Code § 13.1-692.1(B). The duty of loyalty is typically sacrosanct.

Because directors owe undivided duties to continuously represent, and promote, their corporation's residual claimants – the stockholders -- it often comes as something of a surprise to the uninitiated that other corporate constituencies (*e.g.*, employees, lenders, creditors, bondholders) "may be considered only instrumentally to advance that end." *Trados II*, 73 A.3d at 37. Put another way, a director's duties are – without question – owed first and foremost to the stockholders alone. Many directors fall into the trap of thinking they are being magnanimous and faithful to their obligations by taking account the interests of all of the persons who might have a stake in the outcome of a corporate decision, but this is simply error and an invitation to litigation. This is not to say that consideration to these persons cannot be given, but in the end the director of a solvent corporation represents the stockholders, not anyone else. *See Gheewalla,* 930 A.2d at 101 ("When a solvent corporation is navigating in the zone of insolvency, the focus for Delaware directors does not change: directors must continue to discharge their fiduciary duties to the corporation and its shareholders by exercising their business judgment in the best interests of the corporation for the benefit of its shareholder owners."); *Prod. Res. Gp., L.L.C. v. NCT Gp., Inc.*, 863 A.2d 772, 790 (Del.Ch.2004) ("Having complied with all legal obligations owed to the firm's creditors, the board would . . . ordinarily be free to take economic risk for the benefit of the firm's equity owners, so long as the directors comply with their fiduciary duties to the firm by selecting and pursuing with fidelity and prudence a plausible strategy to maximize the firm's value."); *Blackmore P'rs, L.P. v. Link Energy LLC,* 864 A.2d 80, 85–86 (Del. Ch. 2004) ("[T]he allegation that the Defendant Directors approved a sale of substantially all of [the company's] assets and a resultant distribution of proceeds that went exclusively to the company's creditors raises a reasonable inference of disloyalty or intentional misconduct. Of course, it is also possible to infer (and the record at a later stage may well show) that the Director Defendants made a good faith judgment, after reasonable investigation, that there was no future for the business and no better alternative . . . . [I]t would appear that no transaction could have been worse for the unit holders and reasonable to infer . . . that a properly motivated board of directors would not have agreed to a proposal that wiped out the value of the common equity and surrendered all of that value to the company's creditors"); *see also Trenwick Am. Litig. Trust v. Ernst & Young, L.L.P.*, 906 A.2d 168, 191–98 (Del.Ch.2006) (applying business judgment rule to dismiss claims that directors of solvent corporation breached their duties by taking action to benefit subsidiary's sole stockholder at the

expense of its creditors), *aff'd,* 931 A.2d 438 (Del.2007).

Directors must generally consider both the short-term and long-term impact of any particular decision they must make. This is because Delaware and Virginia corporations have a perpetual existence, which means that invested capital is perpetual capital. 8 *Del. C.* §§ 102(b)(5), 122(1); Va. Code §13.1-627(A). Thus, directors owe no corporate duties – and conversely may not show favoritisms -- based upon the identities or personalities of any set of current investors. *See In re Lear Corp. S'holder Litig.,* 967 A.2d 640, 655 (Del.Ch.2008) ("Directors are not thermometers, existing to register the ever-changing sentiments of stockholders . . . . During their term of office, directors may take good faith actions that they believe will benefit stockholders, even if they realize that the stockholders do not agree with them."); *Paramount Commc'ns Inc. v. Time Inc.,* 1989 WL 79880, at *30 (Del.Ch. July 14, 1989) ("The corporation law does not operate on the theory that directors, in exercising their powers to manage the firm, are obligated to follow the wishes of a majority of shares. In fact, directors, not shareholders, are charged with the duty to manage the firm."), *aff'd in pertinent part, Time,* 571 A.2d 1140, 1150 (Del. 1990) ("*Time*"); *TW Servs. v. SWT Acquisition Corp.,* ,1989 WL 20290, at *8 n. 14 (1989) ("While corporate democracy is a pertinent concept, a corporation is not a New England town meeting; directors, not shareholders, have responsibilities to manage the business and affairs of the corporation, subject however to a fiduciary obligation"); *Time,* 571 A.2d at 1154 ("Delaware law confers the management of the corporate enterprise to the stockholders' duly elected board representatives. The fiduciary duty to manage a corporate enterprise includes the selection of a time frame for achievement of corporate goals. That duty may not be delegated to the stockholders").

The foregoing concepts take on special significance when directors are faced with a decision to pursue a strategic alternative that might result in the termination or fundamental alteration of the stockholders' investment. This situation often arises where a corporation is chugging along at a stable but low rate of return, or perhaps is in survival mode but making the numbers year after year, and an opportunity comes for a buy-out or merger. In that case, a board performing its duties should conduct due diligence sufficient to ensure that the value of the deal "on the table" exceeds the value of what the board anticipates the corporation could otherwise

achieve for its stockholders over the long-term.[3] In fact, the law clearly recognizes that stockholders – and today that particularly may mean private capital-based or venture-based stockholders -- may have idiosyncratic reasons to follow agendas that could misallocate capital in the service of their private interests. *Trados II,* 17 A.3d at 38.

The danger is particularly acute when private capital-based and venture-based investors invest in a company and take what is called "preferred stock." Preferred stock is stock of a particular class or series of stock that can hold contractual rights against the corporation such as special dividend rights, rights to convert to common stock, and to veto certain corporate acts. 8 *Del. C.* § 151(a); Va. Code § 13.1-638. "The rights and preferences of preferred stock are contractual in nature." *Trados I,* 2009 WL 2225958, at *7; *accord Judah v. Del. Trust Co.,* 378 A.2d 624, 628 (Del.1977) ("Generally, the provisions of the certificate of incorporation govern the rights of preferred shareholders, the certificate of incorporation being interpreted in accordance with the law of contracts, with only those rights which are embodied in the certificate granted to preferred shareholders."); *Starring v. Am. Hair & Felt Co.,* 191 A. 887, 890 (Del.Ch.1937) (Wolcott, C.) ("The term 'preferred stock' is of fairly definite import. There is no difficulty in understanding its general concept. [It] is of course a stock which in relation to other classes enjoys certain defined rights and privileges."), *aff'd,* 2 A.2d 249 (Del.1937). If there is no corporate governance document (*e.g.*, a certificate of incorporation) that defines "preferred rights," then as to that issue the preferred stock and the common stock have the same rights and is all essentially common stock. *See generally MCG Capital Corp. v. Maginn,* 2010 WL 1782271, at *6 (Del.Ch. May 5, 2010) (noting that preferential contract rights may appear in "the articles of incorporation, the preferred share designations, or some other appropriate document" such as a registration rights agreement, investor rights agreement, or stockholder agreement).

A question that has been posed by many commentators is whether a VC-affiliated director, or a director with a similar connection to another third-party constituency, may simultaneously consider the interests of their employer, patron or ally, or whether they may only consider the interests of the corporation they serve. The answer, recently addressed in detail by Vice-Chancellor Travis Laster, is that such directors may consider the interests of both, but if the

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[3] *Compare Paramount Commc'ns Inc. v. QVC Network Inc.,* 637 A.2d 34, 44 (Del.1994) (holding it was reasonably probable that directors breached their fiduciary duties by pursuing ostensibly superior value to be created by long-term strategic combination when, post-transaction, a controller would have "the power to alter that vision," rendering its value highly contingent), *and Revlon, Inc. v. MacAndrews & Forbes Hldgs., Inc.,* 506 A.2d 173, 182 (Del.1986) (holding that alternative of maintaining corporation as stand-alone entity and use of defensive measures to preserve that alternative "became moot" once board determined that values achievable through a sale process exceeded board's assessment of stand-alone value), *with Paramount Commc'ns, Inc. v. Time Inc.,* 571 A.2d 1140, 1154 (Del.1989) (holding it was not reasonably probable that directors breached their fiduciary duties by pursuing superior long-term value of strategic, stock-for-stock merger without a post-transaction controller) and *Air Prods. & Chems., Inc. v. Airgas, Inc.,* 16 A.3d 48, 108–09 (Del.Ch.2011) (holding that board complied with fiduciary duties by maintaining a rights plan to protect higher stand-alone value of corporation rather than permit immediate sale).

decisions under consideration create a conflict of interest, then resort must be had to procedural mechanisms that will ensure that any decision is carried out or recommended by truly disinterested members of the board or what are called "special committees." *Trados II,* 71 A.3d at 64-65, the court explained that VC-backed board members' failure to resort to multiple different methods of determining fairness to the common shareholders was evidence of disloyalty and unfairness in the context of a merger:

> Conflict blindness and its lesser cousin, conflict denial, have long afflicted the financially sophisticated. Given the directors' intelligence, educational background, and experience, I believe they fully appreciated the diverging interests of the VCs, senior management, and the common stockholders. Despite this reality, the defendants did not consider forming a special committee to represent the interests of the common stockholders. . . . . They also chose not to obtain a fairness opinion to analyze the merger or evaluate other possibilities from the perspective of the common stockholders . . . . At trial, the defendants uniformly cited the cost of a fairness opinion, mentioning figures typical of bulge bracket institutions and their aspiring competitors. But no one appears to have explored the possibility contemporaneously, even after SDL's counsel expressed 'concerns over [the] common stockholders . . . . not getting any consideration,' . . . . and questioned whether Trados needed a 'fairness opinion . . . .' One can remain appropriately skeptical of the value of fairness opinions while at the same time recognizing that an outside analysis of the alternatives available to Trados would have improved the record on fair dealing.

Preferred stockholders are owed fiduciary duties only to the extent they share the rights and privileges of common stockholders. For example, common stockholders can challenge a disproportionate allocation of merger consideration.[4] Preferred shareholders may do so too, provided they are not limited by a contractual entitlement. From a board perspective, what this means is that "it is the duty of directors to pursue the best interests of the corporation and its common stockholders, if that can be done faithfully with the contractual promises owed to the preferred." *LC Capital Master Fund, Ltd. v. James,* 990 A.2d 435, 452 (Del. Ch. 2010). More bluntly, "generally it will be the duty of the board, where discretionary judgment is to be exercised, to prefer the interests of the common stock -- as the good faith judgment of the board

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[4] *See, e.g., In re Delphi Fin. Gp. S'holder Litig.,* 2012 WL 729232, at *12 n. 57 (Del.Ch. Mar. 6, 2012) (considering challenge by common stockholders to transaction in which controlling stockholder received differential merger consideration); *N.J. Carpenters Pension Fund v. Infogroup, Inc.,* 2011 WL 4825888, at *9 (Del.Ch. Sept. 30, 2011) (same); *In re John Q. Hammons Hotels Inc. S'holder Litig.,* 2009 WL 3165613, at *12 (Del.Ch. Oct. 2, 2009) (same); *In re Tele–Commc'ns, Inc. S'holders Litig.,* 2005 WL 3642727, at *7 (Del.Ch. Dec. 21, 2005) (considering challenge to merger in which "a clear and significant benefit of nearly $300 million accrued primarily" to directors holding high-vote common stock (footnote omitted)); *In re LNR Prop. Corp. S'holders Litig.,* 896 A.2d 169, 178 (Del.Ch.2005) (considering challenge by common stockholders to transaction in which corporation was sold to third party but controlling stockholder received right to roll equity in transaction).

sees them to be—to the interests created by the special rights, preferences, *etc* . . . . of preferred stock." *Equity–Linked Investors, L.P. v. Adams,* 705 A.2d 1040, 1042 (Del. Ch. 1997). Consequently, "in circumstances where the interests of the common stockholders diverge from those of the preferred stockholders, it is *possible* that a director could breach her duty by improperly favoring the interests of the preferred stockholders over those of the common stockholders." *In re Trados Shareholders Litig.,* 2009 WL 2225958, at *7 (Del. Ch. 2009) ("*Trados I*"); *accord LC Capital,* 990 A.2d at 447 (quoting *Trados I* and remarking that it "summarized the weight of authority very well"). As with any legal case, everything depends on the facts.

How Courts Analyze Board Decisions Informs A Board About How To Think

There are two important concepts that directors need to keep in mind when they make decisions. The first is the applicable standard of conduct that they must follow. The second is the standard of review that courts will apply when being called upon, after-the-fact, to determine whether directors discharged their fiduciary duties appropriately.

When determining whether directors have breached their fiduciary duties, Delaware corporate law distinguishes between the standard of conduct and the standard of review. *Trados II,* 71 A.3d at 35. The standard of conduct is defined by the content of the twin fiduciary duties of loyalty and care. The standard of review is the test that a court applies when evaluating whether directors have met the standard of conduct.

In Virginia the law is somewhat less clear. On the one hand, Virginia law purports to set a very clear standard of conduct for directors. However, Virginia has yet to embrace the nuanced standard of review applicable in Delaware, and consequently significant uncertainty can exist about how a particular judge may apply the law to the facts in a corporate dispute.

The Standard Of Review

Under Delaware law, there are 3 standards of review that can potentially be applied to director decisions. *Reis v. Hazelett Strip–Casting Corp.,* 28 A.3d 442, 457 (Del.Ch.2011) ("Delaware has three tiers of review for evaluating director decision-making: the business judgment rule, enhanced scrutiny, and entire fairness"). The threshold question, of fundamental importance, is whether the board members who passed judgment on a question were disinterested and independent. If so, a court will apply the very deferential "business judgment rule" to determine whether the action in question was appropriate. *See, e.g., Brehm v. Eisner,* 746 A.2d 244, 263 (Del.2000) (explaining justifications for business judgment rule). If the board faced potential conflicts of interest "because of the decisional dynamics present in particular recurring and recognizable situations," a reviewing court will apply a standard known as "enhanced scrutiny." *Trados II,* 71 A.3d at 36. If the board had actual conflicts of interest such that the directors who passed judgment on an issue did not comprise a disinterested and independent board majority, the board not only loses a presumption that they acted fairly, using proper business judgment, but now the directors must prove that the transaction was "entirely fair" to the corporation and its shareholders or the interested directors may be subject to liability. *Trados II,* 71 A.3d at 44-45.

Virginia does not have a three-tiered approach to a review of director decisions. Instead, Virginia has a codified "standard of conduct" that is seems intended as a codified guide to how good corporate decisions should be made. Va. Code § 13.1-690 states that a director shall discharge his or her duties, including his or her duties as a member of any committee, in accordance with his or her "good faith business judgment of the best interests of the corporation." The Virginia Supreme Court has not looked for, or found, any real nuance in this formulation through the present date. In the absence of Virginia precedent, Virginia lawyers and directors can certainly cite Delaware law, if not follow it, as part of a showing that (in the absence of Virginia precedent) "good faith" efforts were made to reach a measured, fair decision that is in the best interests of the corporation and its stockholders. This is because Delaware law provides, on its face, a set of articulable standards with which to measure and pattern conduct.

That having been said, Virginia has defined when directors are not "disinterested" by statute. Under Virginia Code § 13.1-603, "disinterested director" means:

> . . . except with respect to Article 14 (§ 13.1-725 et seq.) of this chapter, a director who, at the time action is to be taken under § 13.1-672.4, 13.1-691, 13.1-699 or 13.1-701, does not have (i) a ***financial interest*** in a matter that is the subject of such action or (ii) a ***familial, financial, professional, employment or other relationship with a person who has a financial interest*** in the matter, either of ***which would reasonably be expected to affect adversely the objectivity of the director when participating in the action***, and if the action is to be taken under § 13.1-699 or 13.1-701, is also not a party to the proceeding. The presence of one or more of the following circumstances shall not by itself prevent a person from being a disinterested director: (i) nomination or election of the director to the current board by any person, acting alone or participating with others, who is so interested in the matter; (ii) service as a director of another corporation of which an interested person is also a director; or (iii) at the time action is to be taken under § 13.1-672.4, status as a named defendant, as a director against whom action is demanded, or as a director who approved the act being challenged. [Emphasis added]

There is generally no excuse for a Virginia director to end up on the wrong side of a transaction given this guidance.

<u>The Business Judgment Rule -- Delaware</u>

Delaware's presumptive standard of review for director decisions is the "business judgment rule." The rule presumes that "in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company." *Trados II,* 71 A.3d at 44-45. The business judgment rule reflects and promotes the role of the board of directors as the proper body to manage the business and affairs of the corporation. "The court merely looks to see whether the business decision made was rational in the sense of being one logical approach to advancing the corporation's objectives." *In re Dollar Thrifty S'holder Litig.,* 14 A.3d 573, 598 (Del.Ch.2010). Only when a decision lacks any rationally conceivable basis will a court infer bad faith and a breach of duty. *Brehm v. Eisner,* 746 A.2d 244, 264 (Del. Ch. 2000) ("Irrationality is the outer limit of the business judgment rule. Irrationality may be the functional equivalent of the waste test or it may tend to show that the decision is not made in good faith, which is a key ingredient of the business judgment rule." (footnote omitted)); *In re J.P. Stevens & Co., Inc. S'holders*

Litig., 542 A.2d 770, 780–81 (Del.Ch.1988) ("A court may, however, review the substance of a business decision made by an *apparently* well motivated board for the limited purpose of assessing whether that decision is so far beyond the bounds of reasonable judgment that it seems essentially inexplicable on any ground other than bad faith."). That almost never happens. However, if one of the elements of the business judgment rule is rebutted, then the directors who made the decision in question must show that their actions were entirely fair to the corporation and its stockholders.

Enhanced Scrutiny

"Enhanced scrutiny," an intermediate standard of review, requires directors to "bear the burden of persuasion to show that their motivations were proper and not selfish" and that "their actions were reasonable in relation to their legitimate objective." *Mercier v. Inter–Tel (Del.), Inc.*, 929 A.2d 786, 810 (Del.Ch.2007). Enhanced scrutiny applies "to specific, recurring, and readily identifiable situations involving potential conflicts of interest where the realities of the decisionmaking context can subtly undermine the decisions of even independent and disinterested directors." *Trados II,* 71 A.3d at 43. In such cases, the Delaware Supreme Court has been concerned about the "'omnipresent specter' that target directors may be influenced by and act to further their own interests or those of incumbent management, 'rather than those of the corporation and its shareholders.'" *Id.* at 44 (quoting *Unocal v. Mesa Petroleum Co.*, 493 A.2d 946, 954 (Del. 1985) (hostile takeover)).[5]

This standard of review is applied to discrete circumstances. The most common situation for "enhanced scrutiny" occurs when management or other constituencies with something to lose become faced with the loss of power or perquisites, most commonly in the hostile takeover and sale context. In such circumstances, "the [transaction] has enormous implications for corporate managers and advisors, and a range of human motivations, including but by no means limited to greed, can inspire fiduciaries and their advisors to be less than faithful." *In re El Paso Corp. S'holder Litig.*, 41 A.3d 432, 439 (Del.Ch.2012). As further explained in *Dollar Thrifty*:

> The heightened scrutiny that applies in the *Revlon* (and *Unocal*) contexts are, in large measure, rooted in a concern that the board might harbor personal motivations in the sale context that differ from what is best for the corporation and its stockholders. Most traditionally, there is the danger that top corporate managers will resist a sale that might cost them their managerial posts, or prefer a sale to one industry rival rather than another for reasons having more to do with personal ego than with what is best for stockholders.

Dollar Thrifty, 14 A.3d at 597 (footnote omitted). In these cases, "the predicate question of what the board's true motivation was comes into play," and "[t]he court must take a nuanced and realistic look at the possibility that personal interests short of pure self-dealing have influenced

[5] In *Unocal*, the Delaware Supreme Court applied enhanced scrutiny to the decision of directors who took defensive action against a hostile takeover. The directors had to show (i) that "they had reasonable grounds for believing that a danger to corporate policy and effectiveness existed" from the possible takeover and (ii) that the response selected was "reasonable in relation to the threat posed." *Id.* at 955.

the board ...." *Id.* at 598. In the sale context, "enhanced scrutiny requires that the defendant fiduciaries show that they acted reasonably to obtain for their beneficiaries the best value reasonably available under the circumstances, which may be no transaction at all." *Trados II*, 71 A.3d at 44; *see also QVC*, 637 A.2d at 48–49.

Entire Fairness

Entire fairness, Delaware's most onerous standard, applies when the board labors under actual conflicts of interest. Once entire fairness applies, the defendants must establish "to the court's satisfaction that the transaction was the product of both fair dealing *and* fair price." *Cinerama, Inc. v. Technicolor, Inc.* ("*Technicolor III*"), 663 A.2d 1156, 1163 (Del.1995) (internal quotation marks omitted). "Not even an honest belief that the transaction was entirely fair will be sufficient to establish entire fairness. Rather, the transaction itself must be objectively fair, independent of the board's beliefs." *Gesoff v. IIC Indus., Inc.*, 902 A.2d 1130, 1145 (Del.Ch.2006). This is the same standard faced by trustees and fiduciaries in Virginia when they are unable to sustain the burden of proving compliance with Va. Code § 13.1-690. *Simmons v. Miller*, 261 Va. 561, 577, 544 S.E.2d 666, 676 (2001).

To obtain review under the entire fairness test, the stockholder plaintiff must prove that there were not enough independent and disinterested individuals among the directors making the challenged decision to comprise a board majority. *See Aronson*, 473 A.2d at 812 (noting that if "the transaction is not approved by a majority consisting of the disinterested directors, then the business judgment rule has no application"). "To determine whether the directors approving the transaction comprised a disinterested and independent board majority, the court conducts a director-by-director analysis." *Trados II*, 73 A.3d at 45.

The Virginia Formulation of Business Judgment

In Virginia, boards of directors are faced with similar, though sometimes less developed, standards of conduct and review. As noted above, while Delaware law is not binding on Virginia courts, it may be used persuasively to advance the development of Virginia law given the level of thought and scrutiny that similar questions have received in the Delaware court system. Indeed, one leading treatise on Virginia corporate law has recognized that:

> Before Virginia adopted a statutory standard of directors conduct, Virginia courts generally followed the approach of Delaware of relying on common law standards, with the focus on the director's duty of care and his or her duty of loyalty. . . . The practitioner can [still] find the essence of the duties of care and loyalty as well as the concept of good faith embedded in Virginia's statutory standard.

Goolsby and Haas, *Goolsby & Haas on Virginia Corporations*, Kindle Locations 6191-6196 (LexisNexis, Kindle Ed. 2016). As explained below, the concepts of "care" and "loyalty" still apply full force to directors of Virginia companies, both as a matter of statutory law and – somewhat confusingly – still very-much-applicable common law duties. Further, it is clear that in Virginia – as in Delaware – there is a distinction between a director's standard of conduct and the standard of review brought to bear on such conduct by the courts.

Va. Code § 13.1-690 is the "Gold Standard" for director conduct in Virginia. This provision has been called "the most important section of the [entire Virginia Stock Corporation] Act." *Goolsby & Haas on Virginia Corporations, supra* at Kindle Locations 6129-6130. Section 13.1-690 does not abrogate the common law duties of care and loyalty. *Willard v. Moneta Building Supply, Inc.*, 258 Va. 140, 151, 515 S.E.2d 277, 284 (1999). However, the statute provides a roadmap for directors and courts alike in determining how a director should proceed in discharging those duties, and provides a level of protection for the director that follows its path. *See id.* at 150, 515 S.E.2d at 284 ("The General Assembly has mandated the standard by which to evaluate a director's discharge of duties in Virginia"). No one should serve on a board in Virginia without understanding the requirements imposed by Virginia's standards of conduct for directors, particularly since Virginia (unlike Delaware) has not fully fleshed out the contours of these duties.

Section 13.1-690 states that a director shall discharge his or her duties [1] "as a director," including his or her duties as a member of any committee, [2] in accordance with his or her "good faith [3] business judgment of the [4] best interests of the corporation."[6] The statute states that a director shall not be liable for any action taken, or for any failure to act, so long as the director performs his or her duties in conformity with the Act's requirements. Further, any person who alleges a violation of the statute has the burden of proving that violation. As in Delaware, directors can easily mitigate the risk of being second-guessed if they consult the advice of experts, to include lawyers, accountants or other financial advisors. Va. Code § 13.1-690(B)(1-3). In both jurisdictions, they can also appoint "special committees" to study questions and provide recommendations. *Id.; see also* Va. Code § 13.1-689. These tools can be used to

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[6] § 13.1-690. General standards of conduct for director.

A. 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.

B. Unless he has knowledge or information concerning the matter in question that makes reliance unwarranted, a director is entitled to rely on information, opinions, reports or statements, including financial statements and other financial data, if prepared or presented by:

1. One or more officers or employees of the corporation whom the director believes, in good faith, to be reliable and competent in the matters presented;

2. Legal counsel, public accountants, or other persons as to matters the director believes, in good faith, are within the person's professional or expert competence; or

3. A committee of the board of directors of which he is not a member if the director believes, in good faith, that the committee merits confidence.

C. A director is not liable for any action taken as a director, or any failure to take any action, if he performed the duties of his office in compliance with this section.

D. A person alleging a violation of this section has the burden of proving the violation.

circumvent and neuter what might otherwise be debilitating conflicts of interest that could leave a board's decision open to question and litigation.[7]

Breaking this statute down, the following key principles appear relatively clear.

First, a director may not rely on the statute unless she is acting "as a director." Directors, particularly in smaller companies, are also employees or officers. They may also be usurping business opportunities. Decisions or actions that are not truly "director/corporation" decisions or actions – but are more personal in nature -- are not provided any safe harbor by Va. Code § 13.1-690. *Simmons v. Miller,* 261 Va. 561, 577 (2000) ("the protection of § 13.1-690(C) applies only to acts taken as a director, or any failure to take any action, and is confined to the exercise of business judgment on behalf of the corporation. When the acts in question do not meet these criteria, Code § 13.1-690 does not apply") (internal citation omitted). *See also Feddeman & Co., C.P.A., P.C. v. Langan Assocs., P.C.*, 260 Va. 35, 41-44, 530 S.E.2d 668, 672-73 (2000) (analyzing director actions without reference to § 13.1-690 where they were not undertaken as corporate acts but as individual ones). One threshold test to determine whether a director action or decision is implicated is to determine if the director in question was "disinterested" within the meaning of Va. Code § 13.1-603's definition of "disinterested director."[8]

If the statute is not applicable as a threshold matter, then the fiduciary must be judged under traditional principles of care and loyalty, and the burden of production shifts to require the fiduciary to show that her actions were "fair" to the corporation. *Simmons,* 261 Va. at 577 ; *see also Feddeman,* 260 Va. at 41-43, 530 S.E.2d at 672-73 (discussing duties of "good faith and loyalty"); *Giannoti v. Hamway,* 239 Va. 14, 24, 387 S.E.2d 725, 731 (1990) ("And, when transactions have occurred between fiduciaries and those to whom they stand in such relation, the burden of proof lies upon the persons who fill the position of trust and confidence to show

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[7] The use of special committees, and of tools such as limitations on director liability contained in Charters or Articles of Incorporation, is largely beyond the scope of this publication. However, in general, a special committee may consist of 2 or more disinterested directors to study and make recommendations to the board of directors about what is in the best interests of the corporation with respect to all but a few corporate issues. Va. Code § 13.1-689.

[8] "Disinterested director" means, except with respect to Article 14 (§ 13.1-725 et seq.) of this chapter, a director who, at the time action is to be taken under § 13.1-672.4, 13.1-691, 13.1-699 or 13.1-701, does not have (i) a financial interest in a matter that is the subject of such action or (ii) a familial, financial, professional, employment or other relationship with a person who has a financial interest in the matter, either of which would reasonably be expected to affect adversely the objectivity of the director when participating in the action, and if the action is to be taken under § 13.1-699 or 13.1-701, is also not a party to the proceeding. The presence of one or more of the following circumstances shall not by itself prevent a person from being a disinterested director: (i) nomination or election of the director to the current board by any person, acting alone or participating with others, who is so interested in the matter; (ii) service as a director of another corporation of which an interested person is also a director; or (iii) at the time action is to be taken under § 13.1-672.4, status as a named defendant, as a director against whom action is demanded, or as a director who approved the act being challenged.

that the transaction has been fair. *Waddy v. Grimes,* 154 Va. 615, 648, 153 S.E. 807, 817 (1930)"). What this all means, practically, appears to be that directors are completely relieved of the common law burden of proving "fairness" if they show compliance with Va. Code § 13.1-690.

Second, "good faith" is paramount in Virginia, as it is in Delaware. A problem for Virginia corporations, however, is that courts are reluctant to sustain demurrers (based on guidance from the Virginia Supreme Court), despite the fact that the business judgment rule expressly exists to permit directors to make decisions free from fear of frivolous claims and litigation. While many cases are dismissed in Delaware on a motion to dismiss for this reason, corporations in Virginia are more likely to go to trial on issues involving business judgment. In light of the purpose of Va. Code § 13.1-690, courts ought to require litigants to sufficiently allege facts that, if true, would sufficiently demonstrate either that the presumption of the business judgment rule does not apply, or that the presumption will be overcome – *i.e.,* that a challenged decision was knowingly undertaken by a director with an actual conflict of interest or a lack of independence. *See Giannoti v. Hamway,* 239 Va. 14, 24, 387 S.E.2d 725, 731 (1990) (under the business judgment rule, "directors are presumed to have acted properly and in good faith in the exercise of their business judgment, including the fixing of compensation, and are called to account for their actions only when they are shown to have engaged in self-dealing or fraud, or have acted in bad faith").[9] Of course, what this means will be a case-by-case determination, though pleading facts sufficient to show that the transaction in question was not a corporate issue but a personal one, or showing that a sufficient number of directors were not "disinterested," should be sufficient to survive a demurrer. *Feddeman,* 260 Va. at 42, 530 S.E.2d at 672.

Third, the director must exercise "business judgment," not merely "judgment." Coupling the word "business" to "judgment" means, implicitly, that the director has made herself informed on the business aspects of the decision at hand. It therefore requires a reasonable degree of due diligence.

Fourth, the decision must be "in the best interests of the corporation." Critically, this is NOT an objective standard.[10] Litigants and courts are not permitted to substitute their judgment

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[9] One corporate decision has said that "bad faith" conduct can be the result of "'any emotion [that] may cause a director to [intentionally] place his own interests, preferences or appetites before the welfare of the corporation,' including greed, 'hatred, lust, envy, revenge . . . . shame, or pride.'" *In re The Walt Disney Co. Deriv. Litig.*, 2005 Del. Ch. LEXIS 113, *173 (Del. Ch. 2005) (quoting *Guttman v. Huang*, 823 A. 2d 492, 506 n. 34 (Del. Ch. 2003)).

[10] Section 8.30 of the Revised Model Act required a director to discharge his duties (1) in good faith; (2) with the care an ordinarily prudent person in a like position would exercise under similar circumstances; and (3) in a manner he reasonably believes to be in the best interests of the corporation. The General Assembly omitted the "ordinarily prudent person" language, opting instead for a more subjective analysis of director motivations, conflicts and decisional process.

about what is best for a corporation if the director(s) have made (1) a director-based, corporate decision; (2) in good faith; (3) using business judgment. *See Giannoti v. Hamway,* 239 Va. 14, 24, 387 S.E.2d 725, 731 (1990) (stating that courts should be hesitant to second-guess decisions made by a disinterested board). *Simmons v. Miller,* 261 Va. 561, 577 (2000).

An obvious feature of the plain language of Va. Code § 13.1-690 is that the General Assembly wants directors to be given a wide berth, and even be free to make mistakes or decisions that a court might consider "wrong." However, if a director does not live up to the standards set forth in the statute, that ***does not*** and ***should not*** mean that the director assumes liability automatically. It simply means that the director has lost the presumption that her conduct was undertaken in the best in interests of the corporation. Such a director becomes subject to review under traditional fiduciary duty standards for the duties of care and loyalty, just as would be the case if the director had acted in some other role from the outset. A clear example of why this makes sense is the situation where a director acts in an outrageous fashion, in a clearly self-interested, conflicted manner, but the problematic decision turns out to enrich the stockholders more than if the decision had not been made. There may, or may not be, liability in such a case (though, for example, a director might have to repay a disproportionate benefit obtained from self-interested behavior). The point to be made is that Va. Code § 13.1-690 does not completely displace prior law in this area; it is superimposed above it.

Records Requests

Any director or shareholder with issues relating to the operation of a Virginia corporation should be well-versed in their statutory rights with respect the ability to inspect corporate books and records. Directors need access to information to avoid liability for being "asleep at the switch," to make sound decisions, and to be the "watchdog" that the law expects. Shareholders need information to ensure their interests are being faithfully guarded and to "watch the watchers." Most American corporate law involves, after all, a carefully-constructed system of checks and balances.

There is a major difference between director rights and shareholder rights.

To enable directors to carry out their duties, Virginia law assumes that directors must have unfettered access to corporate information at any reasonable time, at corporate offices. Va. Code §13.1-773.1 (setting forth right to "inspect and copy the Company's books, records and documents . . . at any reasonable time to the extent reasonably related to the performance of [his] duties as a director . . . ."). There are no content-based, notice-based, or location-based restrictions imposed on director inspection rights, though such limitations are placed on shareholder inspection rights. *See* Va. Code §13.1-771 (shareholder rights). The authorities make it clear that, in fact, directors are not limited by anything other than the requirement to conduct their inspection at a "reasonable time," such as during normal business hours. *See, e.g.*, 5A Fletcher Cyc. Corp. §§ 2213, 2235 (Perm. Ed. Rev. Vol. 1987); *Cattano v. Bragg*, 283 Va. 638, 650 (2012); *In Re: Management Services Information Litigation*, 81 A.3d 278, 290 (Del. Ch. 2013) ("because of their statutory obligation to manage the business and affairs of the corporation and the concomitant fiduciary duties they owe to the corporation and its

stockholders, individual directors have informational rights that are 'essentially unfettered in nature'"); *McGowan v. Empress Entertainment, Inc.*, 791 A.2d 1, 5 (Del. Ch. 2000).

Shareholders, on the other hand, are required to conduct inspections during regular business hours at the principal office of the corporation. Va. Code § 13.1-771. Records that shareholders may potentially obtain include the following 7 categories upon 5 days prior written notice:

1. The articles or restated articles of incorporation, all amendments to them currently in effect, and certain notices to shareholders.

2. Bylaws or restated bylaws and all amendments to them currently in effect.

3. Resolutions adopted by the board of directors creating one or more classes or series of shares, and fixing their relative rights, preferences, and limitations, if shares issued pursuant to those resolutions are outstanding.

4. The minutes of all shareholders' meetings, and records of all action taken by shareholders without a meeting, for the past three years.

5. All written communications to shareholders generally within the past three years, including the financial statements furnished for the past three years under Va. Code § 13.1-774.

6. A list of the names and business addresses of its current directors and officers.

7. Its most recent annual report delivered to the State Corporation Commission under Va. Code § 13.1-775.1.

As may be seen, the foregoing are very basic categories of information, and do not relate to "inside" views of what may be going on apart from shareholders meetings.

Shareholders may also obtain much more detailed information if there are proper grounds, which will usually only be the case where there is some reason to believe that something nefarious may be going on. In fact, because the business and affairs of the corporation are entrusted, specifically, to the board of directors, it should be the relatively rare case that a shareholder – as shareholder – should get any of the following categories of information:

1. Excerpts from minutes of any meeting of the board of directors, records of any action of a committee of the board of directors while acting in place of the board of directors on behalf of the corporation, minutes of any meeting of the shareholders, and records of action taken by the shareholders or board of directors without a meeting, to the extent not subject to inspection under other provisions of Va. Code § 13.1-770.

2. Accounting records of the corporation.

3. The record of shareholders.

These more detailed categories of information are only available if the request to inspect is made in [1] "good faith" and for a [2] "proper purpose" [3] by an individual who has been a shareholder for at least six months or who owns more than 5% of the issued shares, and [4] at least 5 days in advance, by written notice specifying the "proper purpose."

There is rarely agreement on the level of detail required with respect to the disclosures that appear mandated by the Virginia Code. If the parties cannot agree, there is an expedited procedure available to seek the records from the Circuit Court. As a practical matter, a judge confronted with a Complaint seeking records will attempt to ascertain what the dispute is really about, and will necessarily have to decide whether there appears to be enough in the way of a *bona fide* dispute to permit either more, or less, discovery.

Derivative Suits in Virginia

Shareholders who have suffered unique, personal injuries because of corporate action may sue in their own right, in their own names. Examples would include actions for breach of a personal services contract or personal injury. However, shareholders who feel aggrieved by corporate action that harms all shareholders equally may not maintain a suit in their own name against the corporation. Examples of matters that impact all stockholders equally could include a decision to merge with another entity, or a decision not to pay a dividend. In such cases, a shareholder may sue on behalf of all shareholders, in the name of the corporation.

The leading case in Virginia on derivative claims is *Simmons v. Miller*. *Simmons* involved a situation in which the plaintiff had purchased a 30% interest in the corporation from the person who was, at the time, its sole officer, director and shareholder. Friction ensued, as well as a number of disputes over such issues as the plaintiff's right to inspect the corporation's financial records. The plaintiff then learned that the defendant, without the plaintiff's knowledge, had formed a new corporation and transferred the assets of the first corporation to the new one. The plaintiff filed an individual claim against the defendant for breach of fiduciary duty. The plaintiff argued that he was entitled to bring the case in his name, and not in the name of the corporation, because he was the only party truly injured by the defendant's conduct. However, the Virginia Supreme Court disagreed, effectively finding that action which impacts all stockholders equally is a corporate harm, not an individual one, and that there is no "close corporation" exception to the requirement to bring corporate claims in the name of the corporation. Later, in *Remora Investments, L.L.C. v. Orr*, the Virginia Supreme Court again rejected the argument that prior cases approved "direct causes of action by individual shareholders against directors." 277 Va. 316, 323, 673 S.E.2d 845, 848 (2009). The Court was clear in stating that directors' and officers' fiduciary duties run "to shareholders as a class and not individually." *See id.* Thus, an aggrieved shareholder could not sue in his own right, but only in the right of the corporation.

If a shareholder feels aggrieved about a subject matter that falls within the category of a "corporate injury," it is incumbent on the shareholder to follow a number of procedural steps designed to permit the corporation to defuse a crisis before litigation cripples the corporate enterprise, or at least before corporate resources are wasted. In fact, pursuing a derivative claim is far from being a *fait accompli*. Under Va. Code §13.1-672.1(A):

A shareholder may not commence or maintain a derivative proceeding unless the shareholder:

1. Was a shareholder of the corporation at the time of the act or omission complained of;

2. Became a shareholder through transfer by operation of law from one who was a shareholder at that time; or

3. Became a shareholder before public disclosure and without knowledge of the act or omission complained of; and

4. Fairly and adequately represents the interests of the corporation in enforcing the right of the corporation.

The first 3 requirements of subsection A, above, are all designed to ensure that representative plaintiffs are not opportunistic litigation-oriented trolls who buy shares in order to exploit corporate problems for nothing other than financial gain through the judicial system. The policy decision clearly reflects the idea that only stockholders who are stockholders for "legitimate" should have standing to sue in the name of the corporation, and presumably this is because such persons will have concerns that are more corporate-focused than a mere privateer.

In terms of "fair and adequate" representation, the requirement is designed to ensure that the party representing the corporation takes a fair and balanced approach that is not skewed by idiosynchratic desires for power, money, revenge, fame or other factors unrelated to the merits of the dispute. *See Cattano v. Bragg,* 283 Va. 638, 647, 727 S.E.2d 625, 629 (2012) (restating a nonexclusive list of 8 factors that constitute "fair and adequate" factors).

Even if all the baseline standing issues have been resolved, no derivative proceeding may proceed unless and until a written demand has been made on the corporation to take "suitable action" and 90 days have expired from the date of the demand. There is an exception to the 90 day rule where the stockholder is advised that the demand has been rejected by the corporation, or irreparable injury to the corporation would result by waiting until the end of the ninety-day period. The obvious purpose of this requirement is to permit the board of directors to address, and potentially correct, any real issues. Unlike the case in many other jurisdictions, there is no "futility" exception to the demand requirement.

Boards of directors have numerous ways of defeating derivative claims right away other than on the merits. Initially, the board of directors may cause the corporation to file a motion indicating that a review has been commenced by the board in order to evaluate the claims made by the demand. In such a case, the court may stay any derivative proceeding for such period as the court deems appropriate in order to allow the board to conduct its work.

A board may file a motion (or a plea in bar) to have the derivative claim dismissed if one of the following groups has made a good faith, "informed" determination that the demand/derivative suit lacks merit:

1. A majority of the disinterested directors if they are numerous enough to constitute a quorum; or

2. If no quorum of disinterested directors is possible, a majority vote of a special committee appointed by a majority of the disinterested directors, whatever their number. As discussed above in this publication, the members of the special committee must, themselves, be disinterested and independent in order for their findings to carry any weight.

The findings of one of these two groups should be judged under Va. Code § 13.1-690, since the reviewing group or committee is essentially acting as the full board.

If the corporation files a properly supported motion or plea in bar, the shareholder will need to respond by attempting to allege that the "disinterested" directors were not independent or disinterested, or that their conclusion lacks no rational basis (*i.e.,* that Va. Code § 13.1-690 was not complied with). Yet even if the plaintiff is successful in creating sufficient doubt to give a court pause, the corporation may seek, in the alternative, to have the court appoint a panel of independent persons to make a determination whether the maintenance of the derivative proceeding is in the best interests of the corporation. This set of procedures is clearly designed to ensure that only legitimate derivative claims ever see the light of day.

Finally, a court may award a plaintiff fees and expenses if the suit is deemed to have brought a substantial benefit to the corporation. Va. Code § 13.1-672.5.

Dissolution

In some cases of severe stockholder oppression, or where the basis for incorporation has lost its essential meaning, dissolution of the whole enterprise can be sought. This is a drastic remedy, and the court may dissolve a corporation in a proceeding brought by a shareholder[11] only if the shareholder establishes that:

> a. The directors are deadlocked in the management of the corporate affairs, the shareholders are unable to break the deadlock, and irreparable injury to the corporation is threatened or being suffered, or the business and affairs of the corporation can no longer be conducted to the advantage of the shareholders generally, because of the deadlock; or
>
> b. The directors or those in control of the corporation have acted, are acting, or will act in a manner that is illegal, oppressive, or fraudulent; or
>
> c. The shareholders are deadlocked in voting power and have failed, for a period that includes at least two consecutive annual meeting dates, to elect successors to directors whose terms have expired; or

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[11] Creditors, the board of directors, the corporation itself, and the State Corporation Commission also have rights to seek judicial dissolution under certain circumstances. *See* Va. Code §13.1-747(A)(2)-(3), (5)-(6).

d. The corporate assets are being misapplied or wasted.

Va. Code §13.1-747(A)(1).

A shareholder may also seek judicial dissolution "if the corporation has abandoned its business and has failed within a reasonable time to liquidate and distribute its assets and terminate its corporate existence." Va. Code Ann. § 13.1-747(A)(4).

Deadlock is common, especially in closely held corporations. Because there is no longer an absolute requirement to show irreparable harm before seeking dissolution, deadlock presents the most promising avenue for a disgruntled shareholder to seek dissolution. If the corporation is truly out of control and the annual meeting has not been held for two years, the likelihood of success increases dramatically.

On the other hand, establishing that the corporation's assets are being misapplied or wasted or that the majority has engaged in illegal, fraudulent or oppressive conduct is a relatively tall order. "Waste" or "misapplication" essentially involves a showing of near total dereliction of business judgment by the board, as where capital or resources have been allocated, or not allocated, with essentially no rational basis.

In *White v. Perkins*, 213 Va. 129, 189 S.E.2d 315, the Virginia Supreme Court affirmed a decree of dissolution where the majority shareholder engaging in repeated self-dealing transactions while ignoring the interests and views of the minority shareholder. In so doing, the Court stated that:

> The word 'oppressive,' as used in the statute does not carry an essential inference of imminent disaster; it can contemplate a continuing course of conduct. The word does not necessarily savor of fraud, and the absence of 'mismanagement, or misapplication of assets,' does not prevent a finding that the conduct of the dominant directors or officers has been oppressive. It is not synonymous with 'illegal' and 'fraudulent.'

Put another way, the Court suggested that "oppressive" means a "visible departure from the standards of fair dealing and a violation of fair play on which every shareholder who entrusts his money to a company is entitled to rely." *See also Gianotti v. Hamway, supra* (affirming decree of dissolution and stating that oppressive conduct does not mean that a corporate disaster may be imminent and does not necessarily mean fraudulent conduct; rather, the term can contemplate a continuous course of conduct and includes a lack of probity in corporate affairs to the prejudice of some of its shareholders).

To underline the point that dissolution can occur even in relatively sunny economic circumstances, it should be noted that courts have decreed dissolutions where the corporation in question was profitable and had valuable assets. In *Giannoti*, the corporation's net assets had increased substantially, the corporation continued to operate at a profit, and the value of the outstanding shares had risen. In *Colgate v. The Disthene Group, Inc.* 85 Va. Cir. 286, 2012 WL 9391675 (Aug. 30, 2012), the Circuit Court of Rockingham County (Judge Roush, sitting by special designation) entered a dissolution decree where the corporation owned, among other

things, a mine that produced approximately 90% of the worldwide supply of a very rare mineral, and where the mine had been very profitable. However, the controlling shareholders dominated management, and were a majority of the board. They had used their positions to provide themselves with substantial benefits while suppressing dividends (which hurt the minority shareholders and was designed to pressure the minority to sell below fair value). There was also evidence of unfair dealing with the minority stockholders as a general matter, including excessive executive compensation and personal use of corporate assets without fair compensation to the corporation. Judge Roush concluded that dissolution, although a drastic remedy, was needed to redress the "long-standing and ongoing oppression" of minority shareholders, as well as for waste and misapplication of corporate assets.

While *Disthene* settled before it was heard on the merits in the Virginia Supreme Court, it is the widely-held view of most practitioners that dissolution on the ground of waste or oppression will be a very rare event.

One relatively recent feature of the dissolution statute concerns the right of a corporation faced with a dissolution petition to buy out the aggrieved stockholders at Fair Value. Va. Code § 13.1-749.1. Specifically, if a Complaint or Petition seeking dissolution is filed, the Plaintiff(s) can be bought out at "Fair Value." Not to be confused with "Fair Market Value" (which includes discounts for such things as a lack of marketability and lack of control), Fair Value is typically that fractional interest of the appraised value of the entire corporation based on the percentage of the corporation held by the aggrieved party. The buy-out statute is rather involved and beyond the scope of these materials, but presents a new and interesting angle for parties involved in dissolution proceedings.