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Minority Shareholder Rights in Virginia

By James Irving

In August 2012, Judge Jane Marum Roush, sitting by designation in the Circuit Court of Buckingham County, issued a comprehensive letter opinion in *Colgate et al. v. The Disthene Group, Inc.* The opinion reassessed a substantial portion of the body of law governing the duties of majority shareholders in closely held corporations.

For many years, Gene Dixon Jr. and his son Guy (Gene and Guy) owned all of the voting stock of The Disthene Group, Inc., a successful and diversified business operating in Buckingham County, Virginia. Among other enterprises, Disthene owned the Cavalier Hotel Corporation in Virginia Beach and Kyanite Mining Corporation, the world's largest producer of the minerals kyanite and mullite. Gene and Guy consistently elected themselves and their allies as officers and directors of Disthene and its subsidiaries. Most of the non-voting shares not owned by Gene and Guy were owned by descendants of the company's founder, Gene Dixon Sr., who were relatives of Gene and Guy.

Minority shareholders owning 42 percent of the outstanding shares brought suit, alleging that Gene and Guy had engaged in a pattern of oppressive and fraudulent conduct designed to disadvantage the minority shareholders and had misapplied and wasted corporate assets. Gene and Guy generally denied the allegations and relied on the business judgment rule to justify their actions. The business judgment rule insulates directors of a corporation who "discharge their duties in accordance with good faith business judgment of the best interests of the corporation."

In their lawsuit, the plaintiffs sought the extraordinary remedy of corporate dissolution as provided by section 13.1-747 of the Virginia code. A circuit court is empowered to dissolve a non-public Virginia corporation if it finds, among other things, that the directors have acted in a manner that is illegal, oppressive or fraudulent, or if it finds that corporate assets have been wasted or misapplied. The Supreme Court of Virginia has held that, in this context, "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."

Judge Roush summarized the business judgment rule as providing a safe harbor that shields a director from liability for actions taken or not taken. She further stated that application of the rule presumes that the director acted in absence of personal interest, made an informed decision based on a reasonable effort to become familiar with the facts, acted on a reasonable belief that the decision served the interest of the company, and acted in good faith. Because the rule does not apply unless the director has exercised his or her independent, good faith business judgment, the rule does not offer protection when the director fails to engage in informed decision making or when the decision is made in the best interests of the director as an individual, rather than of the corporation.

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While the rule protects the director, the business judgment doctrine generally protects the decision itself. A director's decision may be invalidated if reached in violation of the business judgment rule, such as through bad faith or gross mismanagement. The judge also noted that the business judgment rule applies to the discharge of duties by directors and not officers but that both corporate officers and directors have a fiduciary duty to exercise good faith in their dealings with shareholders. For example, both officers and directors owe a duty of fair dealing to shareholders seeking to sell their stock back to the company.

Judge Roush found that the plaintiffs had engaged in a long-standing practice of oppression of the minority, had wasted and misapplied corporate assets, and had engaged in misrepresentations and half-truths with respect to the efforts of some minority shareholder to redeem their shares. As a result, Judge Roush agreed to provide the remedy mandated by section 13.1-747; she ordered judicial dissolution of Disthene.

Gene and Guy appealed, but the case settled in August 2013 before the Virginia Supreme Court could review the matter. As a result, Judge Roush's opinion stands as a valuable recitation of Supreme Court precedent and a compendium legal theory. While it is not necessarily the law of the Commonwealth of Virginia, it provides one judge's thought provoking conclusions in this area of corporate law.

A significant portion of Judge Roush's letter opinion was devoted to setting out and analyzing common techniques of the oppression of minority shareholder. These "squeeze-out" techniques include withholding dividends or keeping dividend payments artificially low in order to force minority shareholders to sell the shares at considerably less than actual value and awarding unreasonable jobs, salaries, pay-raises and bonuses to the majority shareholders or their family members.

While courts rarely scrutinize salaries set for directors by a disinterested board, the same deference does not apply when directors set their own salaries. Similarly, when a director has a personal interest in a corporate transaction, the burden is on the director to prove it was reasonable to the corporation. Factors to be considered in judging reasonableness include:

- the qualifications of the employee;
- the nature, extent and scope of the employee's work;
- the type of services rendered;
- the difficulties involved in discharging the responsibilities;
- the success of the business;
- comparison between salary paid to the corporation's net income; and
- comparison of compensation paid to comparable officers in other companies.

In concluding her opinion, Judge Roush noted that "non-voting shareholders… have the right to be treated fairly by the corporate officers and directors." This may be true, but corporate officers and directors often fall short of that standard and the breadth of Judge Roush's ruling is open to question. In different circumstances, the Virginia Supreme Court in *Glass v. Glass* (1984) held that while majority directors owe a fiduciary duty to the stockholders as a class, they could leverage their controlling interest without violating their duty. Controlling shareholders have driven hard bargains ever since.

As a circuit court opinion, *Colgate, et al. v. Disthene Group, Inc.* lacks precedential value and is not binding on other courts. In particular, the defendants cited ten assignments of error in their petition to the Virginia Supreme Court and the Supreme Court did not hear or rule on any of them. Before they could, Gene and Guy Dixon agreed to buy out the minority shareholders for ten times what they once said the stock was worth.

While it is likely that Judge Roush's opinion will spur further shareholder challenges and will be cited by counsel for other abused minorities, only time will prove the staying power of her opinion.

James Irving is a shareholder focusing his practice in business law. He can be reached at jirving@beankinney.com.

Revisions to Federal Non-Party Subpoena Power (Rule 45): Streamlining and Simplifying Outdated Procedures, Effective December 1, 2013

By Rachelle Hill

For the first time since 1991, substantive changes have been made to the Federal Rule of Civil Procedure governing subpoenas effective December 1, 2013. There are five major revisions which were made in an attempt to streamline the process and prevent technical disputes which could invalidate the subpoena. What exactly are these changes and how does it impact the issuance and response procedure and timing?

1. Issuing Court (45(a)(2))

The first revision simplifies the process for issuing subpoenas in multi-jurisdictional cases. Previously the rule required that a subpoena be issued from the court where the deposition was to occur or where the document production was to be made. Now under Rule 45(a)(2) all subpoenas must be issued from the court where the action is pending. Objections will still be made in the district where the place of compliance is specified.

2. Notice Before Service (45(a)(4))

The next clarification is directed at highlighting and slightly modifying advance notice requirements. 45(a)(4) requires that a party serve all document subpoenas on each party in the case "before the subpoena is served on the person to whom it is directed." Previously Rule 45(b)(1) required notice be given to all parties prior to service, however, in practice this frequently did not occur. The Rule was amended to move the notice requirement in 45(b)(1) to a new 45(a)(4) to highlight the advance notice requirement and to require that the notice include a copy of the subpoena.

3. Nationwide Process (45(b)(2))

Another major revision that greatly simplifies the process is that service can now be made nationwide under Rule 45(b)(2). This is consistent with the Federal Rules for Criminal Procedure.

4. Testimony of Non-Parties, Parties and Party Officers (45(c)(1))

Subdivision (c) is new and dictates and simplifies where compliance can be required. Under 45(c)(1)(A) a non-party may be required to comply within 100 miles where the person resides, is employed or regularly does business. Additionally, a non-party may be compelled to travel more than 100 miles to testify in the state where they reside, work or do business only if he or she would not incur "substantial expense."

In regards to party and party officer, compliance may be required anywhere within the state where the party or party officer resides, is employed or regularly does business. A party or party officer cannot be compelled to travel more than 100 miles for trial unless the party or party officer lives in, is employed or regularly does business in the state.

Of note, however, is that this modification does not apply to the depositions of parties or officers, directors or agents of parties as a subpoena is not necessary to take a party deposition. The changes to Rule 45 do not change the existing law and a court may impose sanctions under Rule 37(b), where a party fails to attend a deposition where he or she was properly noticed.

A court will quash any subpoena that requires compliance beyond the geographical limitations in Rule 45(c).

5. Transfer of Enforcement Motions (45(f))

Finally, Rule (45)(f) was revised to enable the court in the jurisdiction where compliance is required to transfer a related motion to the court where the matter is pending. Therefore, if the matter is pending in Virginia but the person who is subpoenaed is located in Minnesota, the Minnesota court can transfer any related motions to Virginia. The transfer is subject to the consent of the party subject to the subpoena [in this example, the person residing in Minnesota] or in exceptional circumstances which the person seeking the transfer bears the burden to show.

Conclusion

In summary, the changes to the non-party subpoena rules should make the process of issuing subpoenas much easier and less likely for parties to make technical mistakes that under the prior rule would have invalidated the subpoena as a matter of law. For instance, under the prior version of the rule issuing a subpoena out of a location other than where the place of production was required was a jurisdictional defect that would invalidate the subpoena on its face. See *Doe I v. Walnuts*, 2008 U.S. Dist. LEXIS 70986 (W.D. Va. Sept. 19, 2008) (holding a subpoena was void where it is issued out of the Western District of Virginia and required production in the Eastern District). Attorneys often raised these technical defects as a way to negotiate the items being subpoenaed. The new rules should hopefully remove any gamesmanship and streamline the process.

Rachelle Hill is an associate focusing her practice on providing business services to regional small to medium-sized companies. She can be reached at 703.525.4000 or rhill@beankinney.com.

Common Copyright Mistakes Small Businesses Make

By Ashley Dobbs

Recently, I was asked, "What are the most common mistakes that small businesses make?" There are several, but the first two that came to mind within the intellectual property arena are 1) failing to make sure they own all rights in their content, whether it's creative work (web content, logo, software, etc.) or their identity (business name, logo, etc.), and 2) misusing others' copyrighted materials.

Failing to Own All Rights

As for the first mistake, too often, small businesses start out doing business on a handshake, rather than getting important agreements detailed in writing. For example, offering a friend "a stake" in the business in exchange for "sweat equity" contributions of marketing, programming, web design, etc. Or

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simply paying a web designer or marketing professional to create content, without ensuring there is a written “work for hire” agreement in place before the work begins. Verbal agreements open the business up to disputes over what “a stake” means (a share of the company? Membership and voting rights?) and who owns the creative content and right to control use of the intellectual property inherent in such materials.

Unless the person is an employee of the business, the copyrights in the materials vest in the creator, not the company, unless appropriate written agreements are in place. This puts the small business at risk for the person to resell, reuse or otherwise compete using the very materials created for their venture. Therefore it’s important to make sure you have written agreements with writers, designers, web designers, programmers, etc. BEFORE they begin working on your project, both identifying the project as a work for hire AND assigning all intellectual property rights to your company.

Using Copyrighted Materials from Others Without Permission

The other key mistake business owners often make is using copyrighted materials from others without permission. For example, copying and using photos or blog posts from the internet without permission can be copyright infringement. Simply attributing the photographer or the source of your content is not sufficient to protect your business from potentially significant liability. There are some limited exceptions, such as “fair use” for criticism, commentary, news reporting, teaching (including multiple copies for classroom use), scholarship or research. But, it’s a particularly fraught area to navigate, so you should consult with a lawyer before you rely on any such defense if you think you can use some portion of someone else’s created work without permission. As a rule of thumb, unless a bit of content was created by you, your employees or someone who’s signed a contract to create content for you, do not use it without written permission from the owner.

Ashley is a shareholder of the firm focusing her practice in intellectual property. Contact her at adobbs@beankinney.com.

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