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Annual Survey of Virginia Law: Business and Corporate Law

Thomas E. Repke

BUSINESS AND CORPORATE LAW

*Thomas E. Repke**

I. INTRODUCTION

This article reviews recent developments in the law affecting Virginia businesses and corporations. Part II discusses several acts of the 1994 session of the Virginia General Assembly that amend Virginia's corporate, partnership, and limited liability company statutes. Part III discusses recent judicial decisions in Virginia courts that address business and corporate law issues.

II. RECENT LEGISLATIVE DEVELOPMENTS

During its 1994 Session, the Virginia General Assembly passed twelve bills in the corporation, partnership, and limited liability company area that were signed into law.[1]

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* Associate, Hogan & Hartson L.L.P., McLean, Virginia; B.A., 1987, The College of William and Mary; J.D., 1990, University of Virginia.

1. The legislation enacted in the corporate, partnership, and limited liability company areas not discussed in this article includes: (1) House Bill 280 which permits public service companies to enter into partnerships, joint ventures, or other associations where the purposes of such relationships are found by the State Corporation Commission (SCC) to be in the public interest and consistent with the provisions of subsection D of Virginia Code §§ 13.1-620 and 56-265.1 to .9. Act of Apr. 8, 1994, ch. 452, 1994 Va. Acts 635-37 (codified at VA. CODE ANN. § 13.1-627(B) (Cum. Supp. 1994)); (2) House Bill 326 which authorizes the SCC to designate the entity with which registration statements for securities filed under Virginia Code § 13.1-509 are to be filed. Act of Mar. 3, 1994, ch. 10, 1994 Va. Acts 15 (codified at VA. CODE ANN. § 13.1-509(C) (Cum. Supp. 1994)); (3) House Bill 1213 which authorizes the SCC to develop regulations to exempt an offer, but not a sale, of a security from the registration requirement of the Virginia Blue Sky Laws if such offer is made by or on behalf of an issuer for the sole purpose of soliciting an indication of interest in receiving a prospectus (or its equivalent) for the security. Act of Apr. 5, 1994, ch. 355, 1994 Va. Acts 500-01 (codified at VA. CODE ANN. § 13.1-514 (Cum. Supp. 1994)); and (4) Senate Bill 75 which authorizes cooperative associations to organize as non-stock corporations and to organize for purposes of conducting any service business or providing financing to entities which have been organized pursuant to the laws of any state. Additionally, the Bill prohibits cooperative associations (except for cooperative

A. *Registered Limited Liability Partnerships*

As a further example of Virginia's commitment to remaining in the forefront of business law issues, Virginia became one of the first states to enact legislation authorizing partnerships to register and operate as limited liability partnerships (L.L.P.s).[2] A L.L.P. is a general partnership in which the partners are protected by statute from vicarious liability for the professional malpractice of other partners and employees. States have enacted L.L.P. statutes in response to the changing nature, size and relationships among partners in general partnerships and concerns regarding the appropriateness of traditional concepts of general partner liability, particularly in connection with the potential liability for the tortious conduct of other partners.[3]

The Virginia L.L.P. legislation[4] amended the Virginia Uniform Partnership Act (UPA) to provide that a partner in a partnership registered as a L.L.P.:

> [i]s not individually liable, directly or indirectly, including by way of indemnification, contribution or otherwise, for debts, obligations and liabilities chargeable to the partnership, whether sounding in tort, contract or otherwise, arising from negligence, malpractice, wrongful acts or misconduct committed while the partnership is [a L.L.P.] and in the course of the partnership business by another partner, employee, agent or representative of the partnership.[5]

The foregoing limitation of liability does not, however, limit the liability of a partner in a L.L.P. for the partner's own negligence, malpractice, wrongful acts or misconduct, or for negligence, malpractice, wrongful acts or misconduct of any employ-

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associations organized to conduct business as a water or sewer company), from conducting business as a public service company. Act of Apr. 4, 1994, ch. 217, 1994 Va. Acts 312-13 (codified at VA. CODE ANN. §§ 13.1-301 to -307, -309, -309.1, -311.1 (Cum. Supp. 1994)).

2. Martin I. Luhawoff, *Registered Limited Liability Partnerships—the Next Wave*, 8 INSIGHTS 23 (1994).

3. *Id.*

4. Act of Apr. 5, 1994, ch. 350, 1994 Va. Acts 483-88 (codified at VA. CODE ANN. §§ 50-2, -6, -15, -18, -34, -36, -40, -43.1 to -43.10 (Repl. Vol. 1994)).

5. VA. CODE ANN. § 50-15(B) (Repl. Vol. 1994).

ee, agent or representative acting under the partner's direct supervision and control in the specific activity in which the negligence, malpractice, wrongful acts or misconduct occurred.[6]

In order to become a L.L.P. under the new legislation, a partnership must file with the Virginia State Corporation Commission (SCC) an application stating:

1. the name of the partnership;

2. the address of its principal office;

3. the post office address of its initial registered office, the name of the city or county in which the office is located, the name of its initial registered agent at that office, and that the agent is either (a) an individual who is a resident of Virginia and is either a partner of the L.L.P., an officer or director of a corporate general partner of the L.L.P., a general partner of a partner of the L.L.P., a member or manager of a limited liability company (L.L.C.) that is a partner of the L.L.P., or a member of the Virginia State Bar, or (b) a professional corporation or professional L.L.C. registered under Code of Virginia section 54.1-3902;

4. a brief statement of the business in which the partnership engages; and

5. a statement that the partnership is applying for status as a registered limited liability partnership.[7]

The initial application for registration must also include a certified copy of the partnership's certificate and a statement as to where and when such certificate was recorded.[8] A majority in interest of the partners or one or more authorized partners must execute the application and submit it with a $100 filing fee to the SCC.[9] Registration is effective for one year after the date the application is filed, unless the application is voluntarily withdrawn by filing a written withdrawal notice with the SCC.[10] The L.L.P. must file a renewal application each year

6. *Id.* § 50-15(C).
7. *Id.* § 50-43.1(A).
8. *Id.*
9. *Id.* § 50-43.1(B)-(C).
10. *Id.* § 50-43.1(E). Under § 50-43.6, a L.L.P. may withdraw from Virginia by filing with the SCC a withdrawal notice executed by a majority in interest of the

within sixty days prior to the expiration of the initial application or any renewal application.[11]

The name of a registered limited liability partnership must include the words "Registered Limited Liability Partnership" or the abbreviation "L.L.P." as the last words or letters of its name.[12] A L.L.P. is required to carry at least $500,000 of liability insurance (beyond the amount of any applicable deductible) designated to cover the kinds of negligence, malpractice, wrongful acts, and misconduct for which liability is limited pursuant to Virginia Code section 50-15(B) discussed above, and which insures the partnership and its partners.[13] Every Virginia L.L.P. and foreign L.L.P. registered in Virginia must maintain the following in Virginia: (1) a registered office that may be the same as any of its places of business; and (2) a registered agent who must be either (a) an individual who is a resident of Virginia and is either a partner of the L.L.P., an officer or director of a corporate general partner of the L.L.P., a general partner of a partner of the L.L.P., a member or manager of a L.L.C. that is a partner of the L.L.P., or a member of the Virginia State Bar, and whose business office is identical with the registered office, or (b) a professional corporation or professional L.L.C. registered under Code of Virginia section 54.1-3902, the business office of which is identical to the registered office.[14]

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partners or by one or more partners authorized to execute a withdrawal notice, which must set forth: (1) the name of the L.L.P.; (2) the date of filing of the initial application for registration; (3) the reason for filing the withdrawal notice; and (4) the effective date (which must be a date certain) of withdrawal if it is not to be effective on the filing of the withdrawal notice, provided that any effective date other than the date of filing of the withdrawal notice must be a date subsequent to the filing; and (5) any other information the partners determine to include therein. *Id.* § 50-43.6.

11. *Id.* § 50-43.1(E). A renewal application must satisfy the same requirements as an initial application, except that the renewal application need not contain a certified copy of the partnership's certificate. The filing fee for a renewal application is $50. *Id.* § 50-43.1(A) & (C).

12. *Id.* § 50-43.2.

13. *Id.* § 50-43.3. A L.L.P is considered to be in compliance with these insurance requirements if the partnership provides $500,000 of funds specifically designated and segregated for the satisfaction of judgments against the partnership or its partners based on the kinds of negligence, malpractice, wrongful acts, and misconduct for which liability is limited by Virginia Code section 50-15(B). A L.L.P. must accomplish this by either (1) a deposit in trust or in bank escrow of cash, bank certificates of deposit, or U.S. Treasury obligations; or (2) a bank letter of credit or insurance company bond. *Id.* § 50-43.3(C).

14. *Id.* § 50-43.3. The sole duty of the registered agent is to forward to the L.L.P.

A foreign L.L.P. must also register with the SCC before transacting business in Virginia.[15] An applicant for registration as a foreign L.L.P. must file with the SCC:

1. a certificate of status from the filing office in the jurisdiction in which the foreign L.L.P. is registered;

2. a copy of the partnership certificate, if any, filed in the jurisdiction where the foreign L.L.P. is registered, duly authenticated by the proper officer of such jurisdiction; and

3. an application executed by a majority in interest of the partners or by one or more partners authorized to execute an application or renewal application, setting forth: (a) the name of the foreign L.L.P. and, if different, the name under which it proposes to transact business in Virginia, which name must comply with Virginia Code section 50-43.2 discussed above, (b) the jurisdiction in which it is registered and the laws of which govern the agreement pursuant to which it was formed, (c) the address of its principal office, (d) the address of a registered office and the name and address of a registered agent for service of process in Virginia required to be maintained in accordance with Virginia Code section 50-43.4, (e) a brief statement of the business in which the partnership engages, and (f) a statement that the partnership is applying for status as a foreign registered limited liability partnership.[16]

Registration as a foreign L.L.P. is effective for one year after the date the application is filed unless voluntarily withdrawn by filing with the SCC a written notice pursuant to Virginia Code section 50-43.8.[17] The foreign L.L.P. must file a renewal

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at its last known address any notice that is served on the registered agent. *Id.*

15. *Id.* § 50-43.7(A).

16. *Id.* § 50-43.7(A), (C). The application must be accompanied by a filing fee of $100. *Id.* § 50-43.7(D).

17. *Id.* § 50-43.7(F). Under § 50-43.8, a foreign L.L.P. authorized to transact business in Virginia may withdraw from Virginia by filing with the SCC a withdrawal notice executed by a majority in interest of the partners or by one or more partners authorized to execute a withdrawal notice which sets forth: (1) the name of the foreign L.L.P., the jurisdiction in which it was registered as a L.L.P. and the laws of which govern the agreement pursuant to which it was formed; (2) that the foreign L.L.P. is not transacting business in Virginia and that it surrenders its registration to transact business in Virginia; (3) that the foreign L.L.P. revokes the authority of its registered agent in Virginia to accept service of process and appoints the Clerk of the SCC as its agent for service of process; and (4) a mailing address to which the

application each year within sixty days prior to the expiration of the initial application or any renewal application.[18]

B. *Virginia Stock and Nonstock Corporations*

1. Required Officers of Corporations

House Bill 176 amends the current corporate law, allowing Virginia corporations greater flexibility in designating the types of officers a corporation must have. The Virginia Stock and Nonstock Corporation Acts previously required a corporation to have a president and secretary. Under the 1994 amendment, a Virginia corporation is now required to have only those officers with the titles and duties as stated in the corporation's bylaws, or in a resolution of the board of directors that is not inconsistent with the bylaws and as may be necessary to enable the corporation to comply with the execution requirements for documents filed with the SCC under Virginia Code sections 13.1-604(F) and 13.1-804(F).[19]

In addition, House Bill 176 amends the Virginia Stock and Nonstock Corporation Acts to provide that, in addition to a corporation's secretary, any other officer designated in the bylaws or by resolution of the board of directors may have responsibility for preparing and maintaining custody of minutes of directors' and shareholders' meetings and for authenticating corporate records.[20]

Clerk may mail a copy of any process served on him under (3) above. *Id.* § 50-43.8.

18. *Id.* § 50-43.7(E)-(F). The filing fee for a renewal application by a foreign L.L.P. is $50.

19. Act of Apr. 2, 1994, ch. 189, 1994 Va. Acts 281 (codified at VA. CODE ANN. §§ 13.1-693(A), -872(A) (Cum. Supp. 1994)). Virginia Code sections 13.1-604(F) and 13.1-804(F) require that once a corporation has been formed and the directors selected, any documents filed with the SCC must be executed by the chairman or vice-chairman of the board of directors, the president, any vice-president, the treasurer, the secretary, or any assistant secretary. VA. CODE ANN. §§ 13.1-604(F), -804(F) (Cum. Supp. 1994).

20. VA. CODE ANN. §§ 13.1-693(C), -872(C) (Cum. Supp. 1994).

2. Merger of Stock and Nonstock Corporations

The General Assembly further amended the Virginia Stock and Nonstock Corporation Acts through passage of House Bill 644. The new legislation specifically authorizes the conversion of a domestic stock corporation to a nonstock corporation and the conversion of a domestic nonstock corporation to a stock corporation.[21]

Under the requirements of the statute, the board of directors of each stock corporation and the governing body of each nonstock corporation must adopt a plan of merger.[22] The plan of merger must set forth:

> (1) The name of each corporation planning to merge and the name of the surviving corporation into which each other corporation plans to merge; (2) The terms and conditions of the merger and the mode of carrying the same into effect; and (3) The manner and basis of converting the shares of each stock corporation and the membership interests of each nonstock corporation into shares, obligations or other securities of the surviving stock corporation or membership interests of the surviving nonstock corporation.[23]

After the plan of merger has been approved by the shareholders and members, if such approval is required under Virginia Code sections 13.1-718 or 13.1-896, or after the plan of merger

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21. Act of Apr. 10, 1994, ch. 646, 1994 Va. Acts 920 (codified at VA. CODE ANN. §§ 13.1-722.1, -898.1 (Cum. Supp. 1994)).

22. VA. CODE ANN. §§ 13.1-722.1(B), -898.1(B) (Cum. Supp. 1994).

23. *Id.* §§ 13.1-722.1(C), -898.1(C). "[I]f any shares of any such stock corporation" or any membership interests of any such nonstock corporation "are not to be converted solely into shares or other securities of the stock corporation or membership interests of the nonstock corporation surviving from such merger," the plan of merger must also set forth:

> the cash, other property, rights or securities of any other corporation or entity which the holders of shares of any such stock corporation or membership interests of any such nonstock corporation are to receive in exchange for, or upon conversion of such shares or membership interests, which cash, other property, rights or securities of any other corporation or entity may be in addition to or in lieu of shares of other securities of any stock corporation or membership interests of any nonstock corporation surviving from such merger.

Id. § 13.1-722.1(C)(3).

has been adopted by the board of directors if shareholder and/or member approval is not required, the surviving corporation must file with the SCC articles of merger setting forth:

> 1. The plan of merger;
> 2. If shareholder approval was not required, a statement to that effect, including the reason approval was not required;
> 3. If approval of the shareholders of one or more stock corporations party to the merger was required, with respect to each such corporation, either: (a) A statement that the plan of merger was adopted by the unanimous consent of the shareholders; or (b) A statement that the plan of merger was submitted to the shareholders by the board of directors in accordance with this chapter and a statement of: (1) The designation, number of outstanding shares, and number of votes entitled to be cast by each voting group entitled to vote separately on the plan; and (2) Either the total number of votes cast for and against the plan by each voting group entitled to vote separately on the plan or a statement that the total number of undisputed votes cast for the plan separately by each voting group and a statement that the number cast for the plan by each voting group was sufficient for approval by that voting group;
> 4. If the members of any merging nonstock corporation have voting rights, then as to each such corporation, either: (a) A statement that the plan of merger was adopted by the unanimous consent of the members; or (b) A statement that the plan was submitted to the members by the board of directors in accordance with the Virginia Nonstock Corporation Act, and a statement of: (1) The existence of a quorum of each voting group entitled to vote separately on the plan; and (2) Either the total number of votes cast for and against the plan by each voting group entitled to vote separately on the plan or the total number of undisputed votes cast for the plan by each voting group was sufficient for approval by that voting group;
> 5. If any merging nonstock corporation has no members having voting rights, then a statement of that fact, the date of the meeting of the board of directors at which the plan was adopted and a statement of the fact that such plan received the vote of a majority of the directors or officers.[24]

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24. *Id.* §§ 13.1-722.1(F), -898.1(F).

If the SCC finds that the articles of merger comply with the requirements of law and that all required fees have been paid, it will issue a certificate of merger.[25]

3. Shareholder Approval for the Conversion of a Corporation into a Holding Company

House Bill 643 effectively allows a corporation with more than three hundred shareholders to become a holding company without obtaining shareholder approval.[26] Virginia Code section 13.1-723(A)(3) enables a corporation with more than three hundred shareholders to transfer any or all of its property to a corporation, all of the shares of which are owned by the transferring corporation, unless otherwise required in its articles of incorporation.[27]

4. Dual Incorporation

The General Assembly also amended the Virginia Stock Corporation Act to subject certain corporations organized under the laws of jurisdictions outside of Virginia to regulation as a Virginia domestic stock corporation.[28] As amended by House Bill 502, the Virginia Stock Corporation Act defines a "corporation" or "domestic corporation" as:

> [a] corporation authorized by law to issue shares, irrespective of the nature of the business to be transacted, organized under [the Stock Corporation Act] or existing pursuant to the laws of [the] Commonwealth on January 1, 1986, *or which, by virtue of articles of incorporation, amendment, or merger, has become a domestic corporation of this Commonwealth, even though also being a corporation organized under laws other than the laws of this Commonwealth.*[29]

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25. *Id.* §§ 13.1-722.1(G), -898.1(G).

26. Act of Apr. 10, 1994, ch. 710, 1994 Va. Acts 1030 (codified at VA. CODE ANN. § 13.1-723 (Cum. Supp. 1994)).

27. VA. CODE ANN. § 13.1-723(A)(3) (Cum. Supp. 1994).

28. Act of Mar. 28, 1994, ch. 122, 1994 Va. Acts 229 (codified at VA. CODE ANN. § 13.1-603 (Cum. Supp. 1994)).

29. *Id.* (emphasis added).

5. Elimination of Requirement of State Tax Commission Certification Upon Termination of Corporate Existence

If a Virginia corporation seeks to file with the SCC articles of termination of corporate existence, or if a foreign corporation applies for a certificate of withdrawal with the SCC, as a result of House Bill 1122, the corporation is no longer required to obtain a certificate from the State Tax Commission certifying that the corporation has paid all state taxes as of the date of such filing.[30] In lieu of the Tax Commission certification, the Bill requires corporations in both instances to certify directly to the SCC that the appropriate returns have been filed and that all state taxes then due have been paid.[31]

6. Limitations on Ownership of Professional Corporations and Memberships in Professional Limited Liability Companies

In House Bill 997, the General Assembly relaxed the limitations on ownership of professional corporations and memberships in professional limited liability companies.[32] Under prior law, each shareholder of a professional corporation and each member of a professional limited liability company was required to be duly licensed or otherwise legally authorized in Virginia to render the same professional services as the corporation or the limited liability company. As amended by House Bill 997, Virginia law now requires that only one of the shareholders of a professional corporation and one of the members of a professional limited liability company be duly licensed or otherwise legally authorized to render the applicable professional services in Virginia.[33]

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30. Act of Apr. 4, 1994, ch. 291, 1994 Va. Acts 404-05 (codified at VA. CODE ANN. §§ 13.1-750(B), -767(C) (Cum. Supp. 1994)).
31. *Id.*
32. Act of Apr. 5, 1994, ch. 349, 1994 Va. Acts 479-82 (codified at VA. CODE ANN. §§ 13.1-543, -544, -545.1, -546, -1102, -1103, -1106, -1107 (Cum. Supp. 1994)).
33. VA. CODE ANN. §§ 13.1-544, -1103 (Cum. Supp. 1994).

C. *Limited Liability Companies*

In House Bill 995, the Virginia General Assembly adopted several amendments to Virginia's Limited Liability Company Act.[34] Most significantly, the Bill eliminated the unanimous consent requirements previously imposed for (1) transfers of member interests, and (2) elections to continue the business of the company upon an event of termination.[35]

Under prior law, an assignee of an interest in a limited liability company could become a member of the company only with the unanimous consent of the other members. As amended by House Bill 995, an assignee may become a member with the consent of all members, or by a lesser percentage or number (but not less than a majority in interest) of the remaining members as may be provided in writing in the articles of organization or the operating agreement of the limited liability company.[36]

The Bill also amended Virginia Code section 13.1-1046 to provide that upon the death, resignation, expulsion, bankruptcy, or dissolution of a member or occurrence of any other event that terminates his membership in a limited liability company, the company must dissolve and its affairs wound up, unless the company's business is continued by all or such lesser percentage or number (but not less than a majority in interests) of the remaining members as provided in the written articles of organization or operating agreement of the limited liability company.[37] Under prior law, the remaining members were required

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34. Act of Apr. 5, 1994, ch. 348, 1994 Va. Acts 477-79 (codified at VA. CODE ANN. §§ 13.1-759, -763, -921, -925, -1015, -1040, -1106, -1107 (Cum. Supp. 1994)).

35. VA. CODE ANN. §§ 13.1-1040, -1046 (Cum. Supp. 1994).

36. *Id.* § 13.1-1040(A).

37. *Id.* § 13.1-1046(A). House Bill 995 also (1) authorizes professional limited liability companies to serve as registered agents of foreign stock and nonstock corporations qualified to do business in Virginia and (2) includes as persons authorized to serve as registered agents of a limited liability company, an officer or director of a corporation that is a member or manager of such limited liability company, and a general partner of a general or limited partnership that is a member or manager of such limited liability company. *Id.* §§ 13.1-759, -763, -921, -925, -1015.

to consent unanimously to continue the business of the company upon the occurrence of such an event.[38]

III. Recent Judicial Decisions

A. *Piercing the Corporate Veil and Personal Liability for the Obligations of a Corporation*

In *O'Hazza v. Executive Credit Corp.*,[39] the Supreme Court of Virginia reaffirmed the general rule that Virginia courts will ignore the separate existence of a corporation and impose personal liability on shareholders for a corporation's debts only in extraordinary situations and when necessary to promote the interests of justice.[40]

Francis E. and Susie W. O'Hazza (the O'Hazzas) formed Sounds You See, Inc., a Virginia subchapter S corporation (the corporation), for purposes of engaging in the business of installing sound equipment in commercial establishments. The O'Hazzas contributed $10,000 of initial capital and were the sole shareholders of the corporation. Guy R. O'Hazza (Guy), a son of the O'Hazzas and the appointed president, was responsible for the day-to-day management of the business. Guy received $4,500 a month from the corporation in the form of a loan in lieu of salary. During the initial two years of operation, the O'Hazzas loaned the corporation approximately $140,000 to cover operating expenses incurred by the corporation. There were no corporate documents that authorized or evidenced these loans. The O'Hazzas testified that they had no expectation of repayment by the corporation.[41]

The corporation entered into a transaction with Executive Credit Corporation (ECC), an equipment leasing broker, pursuant to which ECC advanced funds to the corporation to purchase sound system equipment for installation by the corporation at a hotel. In return, Guy executed a promissory note

38. VA. CODE ANN. § 13.1-1046 (Repl. Vol. 1993).
39. 246 Va. 111, 431 S.E.2d 318 (1993).
40. *Id.* at 115, 431 S.E.2d at 320 (citing Cheatle v. Rudd's Swimming Pool Supply Co., 234 Va. 207, 360 S.E.2d 828 (1987)).
41. *Id.* at 113, 431 S.E.2d at 319.

payable on demand by ECC. Under the terms of the arrangement, ownership of the equipment was to transfer to ECC upon installation, and ECC would lease the equipment to the hotel for a profit. Subsequent to the purchase of the equipment, the management of the hotel disapproved the installation and lease of the equipment, and thus the hotel never consummated the transactions with the corporation and ECC. As a result, the corporation defaulted on its obligations under the ECC promissory note. ECC filed suit to recover the unpaid balance of the note, naming the corporation and the O'Hazzas as defendants.[42]

Disregarding the corporate entity, the trial court entered judgment against the O'Hazzas for the unpaid balance of the note. The court held that the corporation was an instrumentality and alter ego of its shareholders, the O'Hazzas, and was created for the sole purpose of transferring funds to their son.[43] The trial court based its ruling on findings that: (1) the corporation was undercapitalized and would have failed immediately without the loans from the O'Hazzas; (2) the primary purpose of the corporation was to allow the O'Hazzas to provide a constant source of income to Guy through a monthly loan from the corporation; and (3) the subchapter S election by the corporation allowed the O'Hazzas to derive a tax benefit from the operating losses of the corporation, while at the same time avoiding any gift tax associated with the transfer of funds to their son.[44]

The Virginia Supreme Court reversed the trial court's decision, holding that the factors relied upon by the lower court to pierce the corporate veil were insufficient to support the court's conclusions.[45] Under Virginia law, a party seeking to disregard the corporate entity must show that the shareholder the party wishes to hold personally liable controlled or used the corporation to evade a personal obligation, to perpetrate fraud or a crime, to commit an injustice, or to gain an unfair advan-

42. It is unclear from the opinion why Guy was not named as a defendant. The corporation's existence was automatically terminated for failure to pay the annual license fee, and a default judgment was entered against the defunct corporation. *Id.*

43. *Id.*

44. *Id.* at 116, 431 S.E.2d at 321.

45. *Id.*

tage.[46] A court may justifiably pierce the corporate veil when the unity of interest and ownership is such that the separate personalities of the corporation and the individual no longer exist and adhering to that "separateness" would be unjust.[47]

With respect to the trial court's finding that the corporation was undercapitalized, the court stated that if a corporation from its inception is unable to pay its costs of doing business because of "grossly inadequate capitalization," the legitimacy of the separate identity of the corporation is suspect.[48] The burden, however, is on the party seeking to pierce the corporate veil to establish the appropriate level of capitalization for the particular corporation. The court found that ECC failed to establish the appropriate level of capitalization for a business that installed sound equipment.[49]

The court also disagreed with the trial court's findings that the primary purposes of the corporation were to allow the O'Hazzas to provide a source of income to their son and to provide tax benefits to the O'Hazzas.[50] Even if the O'Hazzas established and funded the corporation to provide a personal benefit to their son, the court found that the corporation did not operate solely as a paper entity to pass money from parents to child.[51] Furthermore, the court provided that neither the actual nor the potential tax consequences to the O'Hazzas from the subchapter S election suggested any impropriety which

46. *Id.* at 115, 431 S.E.2d at 320 (citing Lewis Trucking Corp. v. Commonwealth, 207 Va. 23, 31, 147 S.E.2d 747, 753 (1966); F. HODGE O'NEAL & ROBERT B. THOMPSON, O'NEAL'S CLOSE CORPORATIONS § 1.10 (3d ed. 1971 and Supp. 1992)).

47. 246 Va. at 115, 431 S.E.2d at 321 (citing Lewis Trucking, 207 Va. at 32, 147 S.E.2d at 753-54; 1 WILLIAM M. FLETCHER, FLETCHER CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS § 41.30 (perm. ed. rev. vol. 1990)).

48. 246 Va. at 116, 431 S.E.2d at 321.

49. *Id.* The court noted that for legitimate tax reasons, small corporations increasingly choose to capitalize the entity initially with a small portion of the investment represented by stock and with the larger portion of capital set up as loans to the corporation. Furthermore, the court indicated that the loans made by the O'Hazzas could have been characterized as equity rather than debt: "[a] loan made to a corporation by stockholders without expectation of repayment is an indication that the transaction involved venture capital, not a true loan." *Id.* at 117, 431 S.E.2d at 321. The court stated that it had never recognized loaning money to a business that is sustaining losses as a ground for piercing the corporate veil. *Id.*

50. *Id.* at 118, 431 S.E.2d at 322.

51. *Id.*

would justify piercing the corporate veil.[52] Election of subchapter S status for federal tax purposes is a common and legitimate business decision.[53]

B. *Existence of a Joint Venture*

In *Shintom America, Inc. v. Cellular Information Network, Inc.*,[54] the United States District Court for the Eastern District of Virginia declined to find that a joint venture existed between a grocery chain and cellular telephone company engaged in a business transaction to promote the sale of cellular car telephones.[55]

Cellular Information Network, Inc., a Virginia corporation (Cellular) entered into a transaction with Farm Fresh, Inc. (Farm Fresh), a grocery store with locations throughout Virginia, pursuant to which Farm Fresh bought cellular car telephones from Cellular for resale in its grocery stores.[56] Cellular originally purchased the telephones from Shintom America, Inc., a California corporation (Shintom).[57] Farm Fresh advertised in newspapers and on radio stations that the telephones could be purchased at their stores.[58] The advertisements indicated that a credit check and a service contract with Contel, Inc. a Virginia corporation, (Contel) were required of purchasers to ensure that the purchaser could pay his or her cellular telephone bills.[59]

Farm Fresh initiated the credit checks and supplied its customers with Contel's service contract. Once Contel approved the customer's credit, the customer paid Farm Fresh for the telephone. The customer then received a certificate to take to a designated location where the customer received the telephone from Cellular. Cellular subsequently billed Farm Fresh for the

52. *Id.*
53. *Id.*
54. 825 F. Supp. 108 (E.D. Va. 1993).
55. *Id.* at 112.
56. *Id.* at 110.
57. *Id.* at 109.
58. *Id.* at 110.
59. *Id.*

number of telephones sold.[60] A wholly-owned subsidiary of Cellular performed the installation, service activation, and telephone programming pursuant to the service contract between the customer and Contel. In return for such services, Contel paid the subsidiary $350 per telephone installation.[61]

Farm Fresh never held the telephones in its inventory. Moreover, there was no evidence that Farm Fresh required Cellular to maintain a minimum inventory to satisfy the Farm Fresh promotion requirements. Farm Fresh, in its sole discretion, set the prices for the telephones sold at its stores. Farm Fresh was not involved in the ordering and purchasing of the telephones by Cellular from Shintom. Although it was aware of the promotion between Cellular and Farm Fresh, Shintom never required Farm Fresh to provide any information, credit application, guaranty, pledge or other legal obligation to pay for the cellular telephones ordered by Cellular for the Farm Fresh promotion.[62]

Cellular subsequently defaulted on its obligations to pay Shintom for the purchase of certain telephones.[63] In an attempt to make Farm Fresh liable for the debts of Cellular,[64] Shintom alleged that a joint venture had been created between Farm Fresh and Cellular.[65] The district court found that no joint venture existed between Farm Fresh and Cellular because they did not share in the profits or losses of the promotions, nor did they control or manage them.[66]

In making its decision, the district court identified the elements of a joint venture in Virginia: "an agreement, express or implied to (1) jointly share in the profits and losses of an undertaking in which the parties have a community of interest in the object and purpose and (2) have joint and mutual control and management by each party over the other in respects

60. *Id.* at 110-11.
61. *Id.* at 110.
62. *Id.*
63. *Id.* at 109.
64. Prior to trial, Shintom and Cellular settled. Farm Fresh acknowledged the settlement but noted that it did not agree to the amount settled upon and reserved the right to contest any award Shintom claimed due from Farm Fresh. *Id.* at 111.
65. *Id.* at 109.
66. *Id.* at 111.

thereto."[67] The court relied on *Flip Mortgage Corp. v. McElhone*[68] and *Wells v. Whitaker*[69] to support its decision that the elements of a joint venture were not present in *Shintom*.[70]

In *Flip Mortgage*, the Fourth Circuit declined to find that a joint venture existed between a mortgage company and a computer company that had contracted to develop and market a family of computerized mortgage-related services.[71] The computer company managed and operated the business and paid the mortgage company an agreed upon percentage of revenues from operations.[72] Although the mortgage company controlled certain business decisions under the arrangement, the majority of the decisions were made by the computer company.[73] Stressing the lack of both mutual control and sharing of profits and losses, the Fourth Circuit determined that the companies "were engaged in a relatively straightforward contractual relationship,"[74] and thus the evidence did not warrant a finding of a joint venture.[75]

In *Wells*, an explosives mixing plant operator and an explosives supplier entered into an arrangement pursuant to which the operator mixed, sold, and delivered to mining operations certain explosives received from the supplier on consignment.[76] The supplier regularly inventoried the consigned goods at the mixing plant and reviewed plant procedures to advise the operator and its employees how to more effectively operate the plant and maintain its equipment.[77] In declining to find a joint venture between the parties, the Virginia Supreme Court held that the advice and assistance provided by the supplier was akin to providing assistance to a prospective purchaser, and thus was insufficient evidence of any joint control or manage-

67. *Id.*
68. 841 F.2d 531 (4th Cir. 1988).
69. 207 Va. 616, 151 S.E.2d 422 (1966).
70. 825 F. Supp. 108, 111 (E.D. Va. 1993).
71. 841 F.2d at 539-40.
72. *Id.* at 533.
73. *Id.* at 539.
74. *Id.*
75. *Id.* at 539-40.
76. 207 Va. 616, 619-20, 151 S.E.2d 422, 426 (1966).
77. *Id.* at 620, 151 S.E.2d at 427.

ment between the parties.[78] In addition, the court found there was insufficient evidence to show the parties shared any profits or losses:

> Profits accruing from the movement of [goods] from the manufacturer . . . to the processor . . . and then to the ultimate consumer cannot be said to be a sharing of the profits of the processor. *The profit accruing must be joint and several.* Otherwise every person, firm or corporation who furnishes material or supplies in connection with an enterprise might be termed joint ventures, whether or not they had any such intention.[79]

Relying on the holdings of *Flip Mortgage* and *Wells*, the district court in *Shintom* held that there was no evidence of any agreement between Cellular and Farm Fresh to share in the profits and losses of any undertaking. Also, there was no evidence that either Cellular or Farm Fresh had any control over one another in the sale and installation of the cellular telephones. Farm Fresh and Cellular derived their profits from different sources, none of which were shared with the other party. Farm Fresh incurred the majority of the costs of the advertisements and never attempted to recoup such costs from Cellular.[80]

Additionally, as in *Flip Mortgage*, the parties in *Shintom* did not share in the control or management of the sale, installation and servicing of the cellular telephones. Farm Fresh set whatever price it wished for sale to its customers, without regard to Cellular. Any advice Cellular gave to Farm Fresh regarding the advertising was, as in *Wells*, merely technical due to the nature and complexity of cellular service and was rendered so as to not mislead Farm Fresh's customers. Farm Fresh, independently and without control or management by Cellular, determined which of its stores would run the promotions and which part of the store would hold the promotions. Cellular, independently and without control or management by Farm Fresh, acquired the telephones for sale in promotions and installed and serviced the phones after their sale by Farm Fresh. The Court concluded

78. *Id.* at 626, 151 S.E.2d at 430-31.
79. *Id.* at 626-27, 151 S.E.2d at 431 (emphasis added).
80. 825 F. Supp. 108, 112 (E.D. Va. 1993).

that this "relatively straightforward contractual relationship" between Farm Fresh and Cellular did not amount to a joint venture.[81]

C. *Class Certification Under Federal Securities Law*

In *Malone v. Microdyne Corp.*,[82] the United States District Court for the Eastern District of Virginia held that the "fraud on the market" theory in a federal securities fraud case permits class certification despite individual issues of reliance upon alleged misrepresentations.[83]

Microdyne Corporation, a Maryland corporation with offices in Virginia (Microdyne), was engaged in the business of designing, manufacturing, and marketing computer and communications network products and software. Microdyne's common stock is publicly held and traded on NASDAQ. On February 11, 1992, on the basis of information provided by Microdyne's President and Chief Executive Officer, a published securities analyst's report estimated that Microdyne would earn $0.25 per share for its third fiscal quarter ending June 30, 1992. The President told the Dow Jones Newservice that he was "comfortable" with the earnings estimates. On February 12, 1992, the Dow Jones Newswire reported the President's comfort with the published earnings estimates. The price of Microdyne stock increased from $12-1/4 per share on the day of the analyst's report to $13-5/8 per share on the day the Newswire published the President's "comfort" statement.[84]

From February to June, Microdyne publicly promoted its prospects for growth. Primarily, these statements were based on projections of sales of two new products Microdyne introduced in April 1992. In mid-June 1992, Microdyne stated that instead of the $0.25 projected in February, its third quarter earning would be $0.08 to $0.12 per share. Microdyne announced that sales for the two new products would be substantially less than initially projected for the third quarter because of a longer than

81. *Id.*
82. 148 F.R.D. 153 (E.D. Va. 1993).
83. *Id.* at 158.
84. *Id.* at 154-55.

expected product selling cycle, causing profits to be realized later than previously anticipated. After this statement, Microdyne stock fell to $7-1/4 per share.[85]

The June 15 announcement was followed by assurances to the public by Microdyne that the market's response to its two new products was favorable. Microdyne also stated that analysts still projected fourth quarter earnings of $0.14 to $0.21 per share. On October 8, 1992, however, Microdyne stock fell to $3-3/4 per share after Microdyne revealed that projected sales were not realized and that it was going to sustain a fourth quarter loss of $0.17 per share.[86]

Plaintiffs, two investors who purchased Microdyne stock following the President's "comfort" statement in February 1992, brought an action on behalf of themselves and sought to certify a class consisting of all persons who purchased shares of Microdyne common stock between February 12 and October 8, 1992.[87] The defendants argued that class certification was not appropriate because individual issues of reliance would predominate, making a class action inappropriate.[88] The court noted that the plaintiffs' argument involved the causation element of plaintiffs' section 10(b)(5) fraud claim.[89]

To recover under section 10(b)(5) of the Securities and Ex-

85. *Id.* at 155.

86. *Id.*

87. Class certification is governed by Rule 23 of the Federal Rules of Civil Procedure. Rule 23(a) provides that a class action may be maintained only if (i) the class is so numerous that joinder of all members is impracticable, (ii) there are questions of law or fact common to the class, (iii) the claims or defenses of the representative parties are typical of the claims or defenses of the class, and (iv) the representative parties will fairly and adequately protect the interests of the class. Furthermore, a potential class action must be shown to qualify under at least one subsection of Rule 23(b). FED. R. CIV. P. 23(b)(3). Plaintiffs in *Microdyne* relied on Rule 23(b)(3) which states that a class action may be maintained if "the court finds that questions of law or fact predominate . . . over any questions affecting only individual members, and that a class is superior to other available methods for the fair and efficient adjudication of the controversy." 148 F.R.D. at 156 (citing FED. R. CIV. P. 23(b)(3)).

88. Defendants also argued that class certification was inappropriate because two of the plaintiffs faced the prospect of successful defenses to their claims which would be unavailable against other class members, thereby precluding a class action under the "typicality" requirement of Rule 23(a). The court disagreed, finding that the defendants would not have unique defenses against particular plaintiffs. 148 F.R.D. at 159.

89. *Id.* at 156.

change Act of 1934,[90] a plaintiff must establish that the alleged misrepresentation caused the injury suffered by plaintiff.[91] Courts have held that proof of causation in this context requires two discrete showings. First, a plaintiff must prove that he or she engaged in the transaction in question in reliance on the defendant's alleged misrepresentation or omission (so-called "transaction causation").[92] Second, a plaintiff must prove that the misrepresentation or omission caused plaintiff's economic harm (so-called "loss causation").[93] The defendants did not dispute that proof of loss causation could be addressed effectively on a class-wide basis.[94] Rather, they argued that transaction causation is not amenable to resolution on a class-wide basis because plaintiffs must meet this requirement by showing that the alleged misrepresentations or omissions caused the plaintiffs to engage in the subject transaction. Such a showing, the defendants argued, depends on a separate inquiry into the investment motivation of each class member to determine whether each individual's decision to purchase Microdyne stock was influenced by the defendants' alleged misrepresentations.[95]

Because the plaintiffs based their claims on the "fraud-on-the-market" theory sanctioned by the United States Supreme Court in *Basic, Inc. v. Levinson*,[96] the court disagreed with the defendants' argument. In a "fraud-on-the-market" case, the transaction causation element does not require a showing that a defendant's misrepresentations induced *every* plaintiff to enter into a transaction in the affected security. On the contrary, the transaction causation element is satisfied by a showing that a

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90. 15 U.S.C. § 78(b) (1975).

91. 148 F.R.D. at 156 (citing Litton Indus., Inc. v. Lehman Bros. Kuhn Loeb, Inc., 967 F.2d 742, 748 (2d Cir. 1992)).

92. *Id.*

93. *Id.* (citing Bennett v. United States Trust Co., 770 F.2d 308, 313 (2d Cir. 1985), *cert. denied*, 474 U.S. 1058 (1986)).

94. *Id.* at 157. To show loss causation, the court stated that the plaintiffs need only prove that misrepresentations by the defendants inflated the price of Microdyne stock above where the price would have been in the absence of those misrepresentations. If this is shown, the plaintiffs, by purchasing the stock, will have suffered economic loss caused by the defendants' actions. Such proof, the court stated, would not involve facts specific to individual plaintiffs. *Id.*

95. *Id.*

96. 485 U.S. 224, 226-28 (1988).

defendant's act affected the terms (i.e., price) of the transaction.[97] "[T]ransaction causation, in this sense, is precisely the same thing as 'reliance,' as used in the *Basic* opinion and, therefore, if the 'fraud on the market' theory is found to be applicable, transaction causation must be presumed."[98]

According to the court, the "fraud-on-the-market" theory was crafted for the very purpose of avoiding the individualized causation inquiries proposed by the defendants to bar certification of this class.[99] Because the preconditions for application of the "fraud-on-the-market" theory are all questions that can be determined on a class-wide basis (i.e., whether Microdyne stock traded on an efficient market, whether the defendants' misrepresentations were material, etc.) and causation will be presumed if the theory is found to apply, the court concluded that the action was properly pursued as a class action under Federal Rule of Civil Procedure 23(b)(3).[100]

D. *Enforceability of Employer Noncompetition Agreements*

Several decisions during the 1993-94 year addressed the issue of enforceability of employer noncompetition agreements, including one by the Virginia Supreme Court and one by the Fourth Circuit Court of Appeals.

In *New River Media Group, Inc. v. Knighton*,[101] the Virginia Supreme Court overturned a trial court's decision and upheld

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97. 148 F.R.D. at 157 (citing THOMAS L. HAZEN, THE LAW OF SECURITIES REGULATION 467 (1985)).

98. *Id.* at 158 (citing Litton Industry, Inc. v. Lehman Bros. Kuhn Loeb, Inc., 967 F.2d 742, 748 (2d Cir. 1992) (noting that the plaintiff may "establish transaction causation by means of the fraud-on-the-market theory, which permits a plaintiff to rely on the integrity of open, well-developed markets rather than requiring proof of direct reliance on defendant's conduct")); *In re* Control Data Corp. Sec. Litig., 933 F.2d 616, 619 (8th Cir. 1991), *cert. denied*, 112 S. Ct. 438 (1991), ("to the extent that defendant's misrepresentation artificially altered the price of the stock and defrauded the market, causation is presumed").

99. 148 F.R.D. at 158.

100. *Id.* Following the completion of the plaintiffs' evidence at trial, the case was dismissed by the trial court upon the defendant's motion for judgment as a matter of law pursuant to Rule 50 of the Federal Rules of Civil Procedure. The trial court found that the plaintiffs failed to provide evidence that the alleged statements by Microdyne and its officers were misleading. 824 F. Supp. 65, 66 (E.D. Va. 1993).

101. 245 Va. 367, 429 S.E.2d 25 (1993).

the enforceability of a noncompetition agreement.[102] The plaintiff, New River Media Group, Inc. (New River), employed the defendant, David Collins Knighton (Knighton), as a radio disc jockey and operations manager of a radio station in Pulaski, Virginia. When New River terminated Knighton, the parties entered into a written noncompetition agreement. The agreement provided, *inter alia*, that in consideration of $2,000 paid to Knighton by New River, Knighton promised that he would not engage for twelve months in a business that competed with New River within sixty air miles of New River's broadcast station. Two weeks after being terminated by New River, Knighton obtained employment at a radio station located within the sixty-mile radius of New River's station and returned the $2,000 check to New River. Both stations play country music and attract the same advertisers.[103]

New River filed a suit in chancery seeking to enjoin Knighton from working at the competing radio station. Knighton filed a cross-bill, alleging that the agreement was unreasonable and oppressive and, therefore, void and unenforceable. The trial court agreed, finding the agreement to be unenforceable. On appeal, the Virginia Supreme Court reversed the trial court's ruling that the agreement was void and remanded the case to the trial court for entry of a decree enjoining Knighton from violating the noncompetition agreement.[104]

In determining whether a noncompetition agreement is valid and enforceable under Virginia law, the criteria are the following: (a) whether the restraint is reasonable in that it is no greater than necessary to protect the employer in some legitimate business interest; (b) whether the restraint is reasonable in that it is not unduly harsh and oppressive in curtailing the legitimate efforts of the employee to earn a livelihood; and (c) whether the restraint is reasonable from the standpoint of a sound public policy.[105] After consideration of the facts of each

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102. *Id.* at 370, 429 S.E.2d at 27.

103. *Id.* at 368, 429 S.E.2d at 25-26.

104. *Id.*

105. *Id.* at 369, 429 S.E.2d at 26 (citing Roanoke Eng'g Sales v. Rosenbaum, 223 Va. 548, 552, 290 S.E.2d 882, 884 (1982). *Accord* Blue Ridge Anesthesia v. Gidick, 239 Va. 369, 371-72, 389 S.E.2d 467, 468-69 (1990); Richardson v. Paxton Co., 203 Va. 790, 794, 127 S.E.2d 113, 117 (1962)).

case, a court of equity will enforce a noncompetition agreement that passes this three-part test.[106]

The *New River* court found that the agreement at issue satisfied each of the three criteria. The agreement was reasonable because New River had invested substantial time and money in promoting Knighton as an air personality, and the restraint was no greater than necessary to protect New River's legitimate business interests. The restraint was also reasonable as to Knighton because the sixty-mile, twelve-month limit was not unduly harsh and oppressive in diminishing Knighton's legitimate efforts to earn a living. Finally, the court found nothing in the record to suggest that enforcement of the agreement would be unreasonable from a public policy standpoint.[107]

In *Comprehensive Technologies International, Inc. v. Software Artisans, Inc.*,[108] the Fourth Circuit upheld the enforceability of a noncompetition provision in an employment agreement, even though the geographic scope included the entire United States and prohibited the employee from working for a competitor in *any* capacity.[109]

Comprehensive Technologies International, Inc., a California corporation with its principal place of business in Chantilly, Virginia (CTI), entered into a termination agreement with one of its employees (Employee) when Employee resigned from CTI. The agreement provided, *inter alia*, that for a period of twelve months following his departure from CTI, Employee would not:

> [e]ngage directly or indirectly in any business within the United States (financially as an investor or lender or as an employee, director, officer, partner, independent contractor, consultant or owner or in any other capacity calling for the rendition of personal services or acts of management, operation or control) which is in competition with the business of CTI. For purposes of this Agreement, the "business of CTI" shall be defined as the design, development, marketing, and

106. *Id.* (citing Blue Ridge Anesthesia v. Gidick, 239 Va. 369, 372, 389 S.E.2d 467, 469 (1990); Roanoke Eng'g Sales Co. v. Rosenbaum, 223 Va. 548, 552, 290 S.E.2d 882, 884 (1982).

107. *Id.* at 369-70, 429 S.E.2d at 26-27.

108. 3 F.3d 730 (4th Cir. 1993).

109. *Id.* at 740.

> sales of [certain computer software] with the same functionality and methodology.[110]

The United States District Court for the Eastern District of Virginia refused to enforce the covenant not to compete because it was broader than necessary to protect CTI's legitimate business interests. The district court held that the scope of employment restrictions unduly precluded Employee from working for a competitor in *any* capacity. The district court further found that the geographic scope of the agreement was broader than necessary to protect CTI's interests. Because CTI marketed its computer software only in Virginia, Nebraska and one other state, CTI did not have a legitimate interest in restricting Employee's employment throughout the United States.[111]

The Fourth Circuit disagreed and reversed the district court's decision. In applying the same three-part test set forth in *Knighton*, the court first found that the restraint was reasonable from the employer's standpoint, especially since Employee had access to confidential information and trade secrets of CTI.[112] As the court explained,

> [W]hen an employee has access to confidential and trade secret information crucial to the success of the employer's business, the employer has a strong interest in enforcing a covenant not to compete because other legal remedies often prove inadequate. It will often be difficult, if not impossible, to prove that a competing employee has misappropriated trade secret information belonging to his former employer.[113]

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110. *Id.* at 738.

111. *Id.*

112. *Id.* at 738-39 (citing Stoneman v. Wilson, 169 Va. 239, 247, 192 S.E. 816, 819 (1937)). According to the court:

> the fact that the employment is of such a character as to inform the employee of business methods and trade secrets which, if brought to the knowledge of a competitor, would prejudice the interests of the employer, tends to give an element of reasonableness to a contract that the employee will not engage in a similar business for a limited time after the termination of his employment, and is always regarded as a strong reason for upholding the contract.

169 Va. at 247, 192 S.E. at 819.

113. 3 F.3d at 739 (citing Eden Hannon & Co. v. Sumitomo Trust & Banking Co., 914 F.2d 556, 561 (4th Cir. 1990)).

Citing several Virginia Supreme Court cases that upheld covenants similar to the one at issue, the Fourth Circuit disagreed with the district court's finding that the covenant was overbroad because it precluded Employee from working for a competitor of CTI in any capacity.[114] The court also held that the geographic scope of the covenant was not overly broad simply because it covered the entire United States.[115] In support for its finding that CTI had a national market for its products, the court listed ten states in which CTI licensed its computer software, several other states where CTI's value-added resellers marketed the product to its customers, and several other states where CTI had potential customers.[116] Because CTI had a national market for its products, the restrictions on Employee's employment throughout the United States were no greater than necessary to protect CTI from competition by Employee.[117]

The court then determined, under the second prong of the three-part test, that the restriction was reasonable from Employee's point of view because it restricted Employee from engaging in only an extremely narrow category of business.[118] The agreement permitted Employee to design, develop, market, and sell any software of a type different from the two types of software identified in the agreement, any software of the same type having a different functionality or methodology, or any software of the same type having the same functionality and methodology that is not designed to run on personal computers.[119]

114. 3 F.2d at 738-39 (citing Blue Ridge Anesthesia v. Gidick, 239 Va. 369, 374, 389 S.E.2d 467, 468 (1990)) (upholding a three-year covenant under which the employee could not "open or be employed by or act on behalf of any competitor of Employer which renders the same or similar services as Employer."); *Rosenbaum*, 223 Va. at 556, 290 S.E.2d at 882 (upholding a three-year restriction on an employee's right to "own, manage, operate, control, be employed by, participate in, or be associated in any manner with the ownership, management, operation or control of any business similar to the type of business conducted" by the employer.).

115. 3 F.3d at 739.

116. *Id.*

117. *Id.*

118. *Id.* at 740.

119. *Id.* With respect to the third part of the test, Employee did not argue, and the court did not find, that the covenant was unreasonable from the standpoint of public policy. *Id.*

E. *Successor Liability for Tort Claims*

In *Blizzard v. National Railroad Passenger Corp.*,[120] the United States District Court for the Eastern District of Virginia found that a successor corporation was a mere continuation of its predecessor and thus could be held liable for any negligence of the predecessor.[121]

In *Blizzard*, plaintiffs were injured when a passenger train collided with a truck owned by Sears Concrete Corporation (Sears Concrete). Plaintiffs sued the owner and operator of the train (Amtrak) and the owner of the railroad tracks (CSX). Defendants Amtrak and CSX instituted a third-party action seeking contribution and indemnification against Sears Concrete and Sears Contracting Corporation (Sears Contracting), the corporate successor to Sears Concrete.[122] Subsequently, Amtrak and CSX moved for partial summary judgment, contending that because third party defendant Sears Contracting was the corporate successor of Sears Concrete, it was liable for its tort obligations.[123]

Sears Concrete was incorporated in 1985. Its president, Robert J. Sears (Robert) and his son, Randall K. Sears (Randall), its treasurer, were the sole directors and shareholders of the company. Sears Concrete was in the business of making and hauling concrete and excavated material. It owned equipment consisting primarily of trucks and trailers. The company employed, among others, truck drivers and clerical personnel. The company based its operations in Gloucester, Virginia, on land owned by Robert.[124]

In early April 1992, Robert and Randall began the process of forming a new corporation for the purpose of securing more favorable workers' compensation rates. Sears Contracting was

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120. 831 F. Supp. 544 (E.D. Va. 1993).
121. *Id.* at 548-49.
122. Amtrak and CSX also sought to join Sears Sand and Gravel, Inc., but the court dismissed the action against that entity because it ceased to exist in 1989. *Id.* at 545.
123. *Id.*
124. *Id.* Sears Concrete, however, did not pay Robert for use of the land. *Id.* at 545-46.

incorporated on May 1, 1992, two days after the accident at issue. Three weeks later, Sears Concrete transferred its equipment to Sears Contracting. Sears Concrete received no consideration for any equity it had in the equipment, but Sears Contracting assumed responsibility for the remaining balances owed on the equipment. As with Sears Concrete, Robert and Randall were the sole directors and shareholders of Sears Contracting, with Randall named as president and Robert as secretary. The employees of Sears Concrete became employees of Sears Contracting and held the same positions and performed the same tasks as they had prior to the formation of Sears Contracting. The new company operated out of the same offices and same physical location as the old company, and maintained the same address and telephone number. Although Sears Contracting's product line expanded over time, at the time of its incorporation, Sears Contracting sold the same services and products to the same customers as had Sears Concrete. Despite not being dissolved, Sears Concrete ceased doing business upon the formation of Sears Contracting.[125]

Generally, a corporation that purchases the assets of another corporation is not liable for the debts and contingent liabilities of the selling corporation.[126] However, as stated by the Virginia Supreme Court in *Harris v. T.I., Inc.*, Virginia recognizes four traditional exceptions to the general rule that a successor corporation does not assume the liabilities of the predecessor entity.[127]

> In order to hold a purchasing corporation liable for the obligations of the selling corporation, it must appear that (1) the purchasing corporation expressly or impliedly agreed to assume such liabilities; (2) the circumstances surrounding the transaction warrant a finding that there was a consolidation or *de facto* merger of the two corporations; (3) the

125. *Id.* at 546. According to Robert, Sears Concrete retained its corporate existence primarily because of the litigation. *Id.*

126. *Id.* at 547 (citing Bud Antle, Inc. v. Eastern Foods, Inc., 758 F.2d 1451, 1456 (11th Cir. 1985); Leannais v. Cincinnati, Inc., 565 F.2d 437, 439 (7th Cir. 1977); Travis v. Harris Corp., 565 F.2d 443, 446 (7th Cir. 1977); Crawford Harbor Assocs. v. Blake Constr. Co., 661 F. Supp. 880, 883 (E.D. Va. 1987) (applying Virginia law)); *see also* 15 WILLIAM M. FLETCHER, FLETCHER CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS § 7122 (perm. ed. 1990).

127. 243 Va. 63, 70, 413 S.E.2d 605, 609 (1992).

> purchasing corporation is merely a continuation of the selling corporation; or (4) the transaction is fraudulent in fact.[128]

Although the Virginia Supreme Court has not explicitly addressed the concept of a *de facto* merger in the area of successor liability, the *Blizzard* court cited the statement in *Harris* that Virginia would likely adopt the "traditional view" of the *de facto* merger exception.[129] The elements of the traditional view are the following:

> (1) a continuity of the selling corporation's enterprise, including management, personnel, physical location, assets, and general business operations; (2) a continuity of ownership because the purchasing corporation acquires the assets with shares of its own stock, which ultimately are held by the selling corporation's shareholders; (3) prompt liquidation and dissolution of the selling corporation's business operations; and (4) an assumption by the purchasing corporation of the selling corporation's obligations necessary for normal operation of the seller's business.[130]

Of the four elements of the *de facto* merger exception, the key element is the "continuity of ownership" of the corporations.[131] Because there was no sale or transfer of stock of Sears Concrete to Sears Contracting in the *Blizzard* case, the court held that the circumstances surrounding the creation and incorporation of Sears Contracting did not warrant a finding of a *de facto* merger under Virginia law.[132]

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128. *Id.* Amtrak and CSX did not contend that Sears Contracting agreed to assume Sears Concrete's liabilities or that the incorporation of Sears Contracting was fraudulent. Rather, they argued that a *de facto* merger occurred between the two companies or that Sears Contracting was a "mere continuation" of Sears Concrete. 831 F. Supp. at 545.

129. 831 F. Supp. at 547 (citing *Harris*, 243 Va. at 69-72, 413 S.E.2d at 609-10).

130. *Id.* (citing *Bud Antle*, 758 F.2d at 1457-58; *Crawford Harbor*, 661 F. Supp. at 884).

131. *Id.* (citing Leannais v. Cincinnati, Inc., 565 F.2d 437, 439-40 (7th Cir. 1977); Travis v. Harris Corp., 565 F.2d 443, 447 (7th Cir. 1977) ("Absent a transfer of stock, the nature and consequences of a transaction are not those of a merger"); *Crawford Harbor*, 661 F. Supp. at 884 ("The essential characteristic of a *de facto* merger is the succession of the selling corporation's stockholders to stockholder status in the purchasing corporation.").

132. 831 F. Supp. at 548.

The court did, however, find that Sears Contracting was a "mere continuation" of Sears Concrete and thus, could be held liable for the torts of Sears Concrete.[133] "In determining whether one corporation is a 'mere continuation' of another under the traditional doctrine,[134] the essential inquiry is whether there has been a continuation of the corporate entity of the seller, not whether there has been a continuation of the seller's business operations."[135] The key element of this inquiry is whether there is "a common identity of the officers, directors and stockholders in the selling and purchasing corporations."[136]

The court held that Sears Contracting was a "mere continuation" of Sears Concrete because: (1) Robert and Randall were the sole stockholders and directors of both companies, which had the same officers; (2) Sears Contracting voluntarily assumed the corporate identity of Sears Concrete, in its capacity as debtor, by taking over the payment obligations on Sears Concrete's equipment, and in its capacity as employer, by continuing to employ the employees of Sears Concrete without any hiatus in their employment; and (3) the two companies used the same office, address and telephone number, as well as delivery tags which bore the name and former telephone number of Sears Concrete.[137]

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133. *Id.*

134. *Id.* (citing *Harris*, 243 Va. at 69-72, 413 S.E.2d at 609-10).

135. *Id.* at 548 (citing *Bud Antle*, 758 F.2d at 1458; *Travis*, 565 F.2d at 447; *Crawford Harbor*, 661 F. Supp. at 885; Niccum v. Hydra Tool Corp., 438 N.W.2d 96, 98 (Minn. 1989)).

136. *Id.* at 548 (quoting *Harris*, 243 Va. at 70, 413 S.E.2d at 609). Among these three required factors (officers, directors and stockholders), the court stated that identity of stockholders is the most important component to sustain a finding of "mere continuation." *Id.* (citing Weaver v. Nash Int'l. Inc., 730 F.2d 547, 548 (8th Cir. 1984); Emerson Elec. Co. v. Kego Corp., 1991 WL 36954, at *6, 1991 U.S. Dist. Lexis 3140, at *16-17 (N.D. Ill. March 13, 1991)).

137. 831 F. Supp. at 548. The court noted that its conclusion was not altered by the fact that Sears Concrete continued to exist following the incorporation of Sears Contracting. "Where all other evidence points to continuity, the single remaining corporation factor does not preclude a finding of mere continuation." *Id.* at 549.