

Publications

## INDIVIDUAL SHAREHOLDER DERIVATIVE SUITS AND JUDICIAL DISSOLUTION

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### Business Law Practice Tip

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In its recent decision in *Cattano v. Bragg*, the Virginia Supreme Court clarified and recognized the right of an individual shareholder to file a derivative suit on behalf of a corporation with two shareholders, along with an individual suit and an action for judicial dissolution. The Court adopted the factors used in *Jennings v. Kay Jennings Family Limited Partnership*, 275 Va. 594 (2008) to determine whether Bragg had standing to bring a derivative claim based on her ability to "fairly and adequately represent the interests of the corporation." Further, as a matter of first impression, the Court considered the appropriateness of awarding attorneys' fees. The Court adopted the United States Supreme Court's substantial benefit test from *Mills v. Electric Auto-Lite Company*, 396 U.S. 375 (1970). A substantial benefit is "something more than technical in its consequence and ... accomplishes a result which corrects or prevents an abuse which would be prejudicial to the rights and interests of the corporation or affect the enjoyment or protection of an essential right to the stockholder's interest." The holding suggests that minority shareholders have significant rights and remedies.

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### *Cattano v. Bragg*

No. 110692 - Virginia Supreme Court - April 20, 2012

#### Issues:

- Whether a minority shareholder has standing to bring a derivative suit while seeking judicial dissolution of a corporation.
- Whether attorneys' fees are appropriate in this type of action.

#### Short Answer:

- Yes.
- Yes.

Facts: This case involves a dispute between the only two shareholders of a law firm organized and structured as a corporation. Bragg questioned checks written from the escrow/trust account by Cattano and asked Cattano that the corporate records be made available to her. Cattano, the majority shareholder, terminated Bragg's employment by the corporation. Subsequently, Cattano held a shareholder meeting and voted to remove Bragg as a Director of the Corporation.

Initially, Bragg filed suit individually seeking judicial dissolution, accounting of assets and division of the assets. She amended her complaint to add derivative claims. At trial, the jury found for Bragg on her derivative claim for conversion (awarding \$234,412 to the firm) and also awarded damages for breach of contract (\$10,416) and



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judicial dissolution (\$7,409). In a separate trial, the Circuit Court awarded Bragg \$269,813 in attorneys' fees, plus \$19,415 in costs and expenses, for providing a "substantial benefit" to the corporation because of the successful derivative action.

Cattano appealed claiming *inter alia* the following: (1) Bragg did not have standing to file the derivative claim because she could not fairly and adequately represent the interests of the corporation; (2) the circuit court erred in failing to instruct the jury on the issue of fair and adequate representation; (3) attorneys' fees are inappropriate; and (4) the proceeding did not substantially benefit the corporation.

Right to File Derivative Action:

The Virginia Supreme Court affirmed Bragg's right to file a derivative claim. The Court first confirmed that an individual shareholder can bring a derivative action (citing *Simmons v. Miller*, 261 Va. 561 (2001) and referring to case law in other jurisdictions). The Court then addressed Bragg's ability to "fairly and adequately" represent the interests of the corporation. The Court considered the factors outlined in *Jennings*, 275 Va. 594. The test sets forth that the following should be considered in determining whether an individual meets the standard for fair and adequate representation:

- (1) economic antagonisms between the representative and members of the class;
- (2) the remedy sought by the plaintiff in the derivative action;
- (3) indications that the named plaintiff is not the driving force behind the litigation;
- (4) plaintiff's unfamiliarity with the litigation;
- (5) other litigation pending between the plaintiff and defendants;
- (6) the relative magnitude of plaintiff's personal interests as compared to his interests in the derivative action itself;
- (7) plaintiff's vindictiveness toward the defendants; and
- (8) the degree of support plaintiff is receiving from the shareholders he purports to represent.

*Id.* at 601-02. While some of the factors are present, the Court looked at the totality of the circumstances and determined a derivative action was proper because Bragg was able to fairly and adequately represent the interests of the corporation. An important element of the Court's rationale was that economic antagonism and high emotions are always part of derivative suits in closely held corporations. Therefore to bar a suit based on the presence of those two factors alone, would create a *de facto* rule against shareholder derivative suits in two-shareholder corporations. Similarly, the Court permitted the filing of a judicial dissolution and a shareholder derivative suit at the same time because judicial dissolution is a "remedial mechanism that exists in addition to, rather than as a substitute for, shareholders [sic] rights."

Appropriateness of Attorneys' Fees:

Also, and importantly, as a matter of first impression, the Court evaluated whether Bragg rendered a substantial benefit to the corporation/law firm. Pursuant to Virginia Code §13.1-672.5(1), as amended, on conclusion of a derivative proceeding, the court shall: "order the corporation to pay the plaintiff's reasonable expenses incurred in the proceeding if it finds that the proceeding has resulted in a substantial benefit to the corporation . . ." In construing the meaning of "substantial benefit," the Court adopted the United States Supreme Court decision in *Mills*, 396 U.S. at 396 (finding that a substantial benefit is something more than technical in its consequence and accomplishes something that corrects or prevents abuse). Bragg won a \$234,000 jury verdict for the firm, which the Court determined substantial.

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This decision is significant because it adds to a limited amount of case law in the area of derivative actions in closely held corporations. Importantly, it allows a minority shareholder to bring individual claims, derivative claims and claims for judicial dissolution in the same action without creating a conflict of interest. It also serves as an example of the high penalties that can be awarded when the owner or majority shareholder is found to have abused power.

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