

# THE LAW OFFICE OF RICHARD A. MCFARLANE

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August 7, 2003

**BY FIRST CLASS MAIL**

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**RE: Redacted**

Client: Redacted  
Subject: Membership in Virginia Non-stock Corporations

Dear Redacted:

In a stock corporation, the stockholders are, for the most part, a self-selected group who have either bought their shares or received them as a gift or inheritance. Further, the stockholders can sell or otherwise alienate their shares if they no longer wish to remain stockholders and be associated with the corporation. However, in the case of a nonstock, membership corporation the relationship of members to the corporation is not so clear. Especially when the

Virginia Code Annotated section 13.1-837 provides:

A [nonstock] corporation may have one or more classes of members or may have no members. If the corporation has one or more classes of members, the designation of such class or classes and the qualifications and rights of the members of each class shall be set forth in the articles of incorporation or, if the articles of incorporation so provide, in the bylaws. A corporation may issue certificates evidencing membership therein. Memberships shall not be transferable. Members shall not have voting or other rights except as provided in the articles of incorporation or if the articles of incorporation so provide, in the bylaws.

THE LAW OFFICE OF RICHARD A. MCFARLANE

Redacted

August 7, 2003

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I could find no case law from Virginia dealing directly with the question of electing members to nonstock corporations; however, I found several cases which deal with the election of directors which I have analogized. For example, in the case *Stewart v. Lady* (1996) 251 Va. 106, 110; 465 S.E.2d 782, the Virginia Supreme Court held “[Virginia] Code § 13.1-803 defines the term “board of directors” of a nonstock corporation . . . as “the group of persons vested with the management of the business of the corporation irrespective of the name by which such group is designated,” and “director” is defined as “a member of the board of directors.” Code §§ 13.1-855(D) states in part, “directors shall be elected or appointed in the manner provided in the articles of incorporation.” Code §§ 13.1-857(B), which governs terms of directors generally, states: “The directors constituting the initial board of directors shall hold office until the first annual election of directors or for such other period as may be specified in the articles of incorporation. Thereafter, directors shall be elected or appointed in the manner and for the terms provided in the articles of incorporation.”

Since the Charter controls the election of directors it ought to control the election of members. Since the Charter requires Charter Members to be elected by other Charter Members, with one exception, it follows that the last Charter Member, Richard Gibson, is the only person who has the power to elect another Charter Member. The only person he has elected is Robert Lehman.

In the case *Blue Ridge Property Owners v. Miller* 216 Va. 611, 613, 221 S.E.2d 163 (1976), the Virginia Supreme Court stated the rule, “Failure (of a corporation) to elect officers results in continuing the old officers in power. Thus, where the corporation fails to hold its regular annual meeting for the election of directors, the directors then in office hold over until their successors are elected” [Citation].”

In the case *Lewis v. Glenn* 84 Va. 947, 870-871, 6 S.E. 866 (1888), the Virginia Supreme Court ruled that, one of the defendants, “Joseph R. Anderson, director [of the defendant corporation], appeared and answered in person, not admitting that he was a director and entitled to answer officially, but averring to the best of his knowledge and recollection, that he had resigned his directorship soon after his election. But the record shows that he was a director, and acted as such at the last meeting of the board of directors ever held. Moreover, as the charter of the company expressly provides that ‘the president and directors of this corporation shall hold their offices for one year, and until their successors are chosen,’ and it not being pretended that any one was ever chosen as his successor, it is indisputably true that he was a director, and was properly served.” See also Michie’s Jurisprudence of Virginia and West Virginia, Corporations, § 154

Since directors hold over in office until their successors have been chosen, members, who have the responsibility and the power to elect the directors, hold over until their successors are

THE LAW OFFICE OF RICHARD A. MCFARLANE

Redacted

August 7, 2003

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chosen too. Therefore, Mr. Gibson held over as a Charter Member until he chose his successor, Mr. Lehman, in March 2001.

I do not believe that Va. Code § 13.1-846(c) which provides for the election of directors by the board of directors when there are no members or the members have no voting rights is applicable here notwithstanding Va. Code § 13.1-837 which provides that a corporation may have no members because of the holding in *Stewart v. Lady*. Va. Code § 13.1-837 provides in relevant part, "A corporation may have one or more classes of members or may have no members. If the corporation has one or more classes of members, the designation of such class or classes and the qualifications and rights of the members of each class shall be set forth in the articles of incorporation or, if the articles of incorporation so provide, in the bylaws." In addition, in *Virginia High School League, Inc. v. J.J. Kelly High School* 234 Va. 528, 531, 493 S.E.2d 362 (1997), the Virginia Supreme Court held, "Ordinarily, nonstock corporations and their members are controlled by the corporate bylaws. And, courts apply the bylaws in resolving disputes between those parties. ¶Moreover, the rules used to interpret statutes, contracts and other written instruments are applicable when construing corporate bylaws. Hence, courts will not attempt to look beyond the language of bylaws written in unambiguous terms. [Internal citations and quotation marks omitted.]"

Given that the charter controls the statute and that Charter provides that only Charter Members can elect other Charter Members except when all the Charter Members are deceased and given that Mr. Gibson still lives, only Mr. Gibson could have elected another Charter Member to take his place. Therefore, the election of Mr. Lehman to charter Membership is valid and the election of Mr. Kennedy and Maxus Development to Charter Membership is void.

In addition to the forgoing Virginia cases, I think the following non-Virginia authorities helpful: "To support her theory, [Defendant] Duggan cites Constructors' Ass'n of Western Pennsylvania v. Furman, 165 Pa.. Superior Ct. 248, 67 A.2d 590 (1949). The Society correctly notes, however, that *Constructors' Ass'n* involved an application for membership to an organization rather than resignation from membership of an organization. The court in *Constructors' Ass'n* held that "[t]he application was [an] offer to become a member of the association under the terms of its by-laws; the acceptance of [the] offer formed a contract; and the by-laws by reference became the terms of the contract." Id., 165 Pa.. Superior Ct.. at 250, 67 A.2d at 591." *Bradford County Humane Society v. Duggan*, 143 Pa. Commw. 635, 638-639; 600 A.2d 639; (Pa. Commw 1991) [Emphasis added] The right of a member to withdraw is limited or restricted only where there is some contract involved or a provision in the corporation's by-laws. 12A *Fletcher's Cyclopedia Corporations* § 5694.40.

By accepting charter membership, Mr. Gibson and NFH made a contract that includes the implied provision that Mr. Gibson will not resign without appointing a successor. This is

THE LAW OFFICE OF RICHARD A. MCFARLANE

Redacted

August 7, 2003

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implied from the following facts: (1) Only persons dedicated to NFH's goals may become charter members; all others are associate members. (2) Only charter members may elect other charter members and directors. (3) Charter members may only be removed by the other charter members. The contract requires Charter Members to appoint their successors before resigning. Therefore, Mr. Gibson either remained a Charter Member until he appointed Mr. Lehman, or retained the power to appoint a Charter Member despite his resignation.

In the case *Oberly v. Kirby* (Del. 1991) 592 A.2d 445, on facts similar to those found in the NFH case, the Delaware Supreme Court ruled that the corporate charter of a nonprofit, nonstock corporation is "in the nature of a contract." *Id.* at 457. The Court continued, "The rules of contractual construction also support our interpretation of the Certificate. Article EIGHTH, Section 1 unambiguously vests the members with the power to elect new members. Section 2, while giving the directors power to regulate membership, does not mention the election of members. If the drafters of the Certificate had intended to give the directors such power, they could have done so explicitly." *Id.* at 459.

Here, the incorporators of NFH could have provided for the directors to elect new members if the membership became vacant for any reason. Yet, they did not. The Charter clearly and unambiguously states that the directors are entitled to vote for new members only if all the old members are deceased. This is not the case here. Therefore, the board of directors (that is, Mr. Kennedy) was without power to elect a charter member.

For the reasons stated, I believe that Mr. Lehman was legitimately elected as a Charter Member and was within his authority and rights to elect a new board of directors replacing Mr. Kennedy.

3. Purported By-laws and a lack of quorum

The second issue is whether the amendments to the charter and bylaws passed by Richard Kennedy in December 2000 are valid. As mentioned, the purported amendments to the bylaws were passed by Mr. Kennedy acting as the sole director. Although the bylaws have space for three signatures, the only signature is Mr. Kennedy's.

According to the Charter, article XII, "These Articles of Incorporation [that is, the Charter] may be amended at any time and from time to time by the affirmative vote of majority of all the directors then in office. The articles of amendment shall set forth the date of the meeting of the Board of Directors at which the amendment was adopted, and a statement of the fact that such an amendment received the vote of a majority of all the directors then in office."

According to the Bylaws, section 13.1, "The Board of Directors shall have power to alter, amend or repeal these bylaws or adopt new bylaws." According to the Bylaws, section article 13.2, "Action by the Board of Directors with respect to bylaws shall be taken by a majority vote of all the Directors then in office."

THE LAW OFFICE OF RICHARD A. MCFARLANE

Redacted

August 7, 2003

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According to the Bylaws, section 4.6, "At meetings of the Board of Directors, a majority of the Directors then in office shall be necessary to constitute a quorum for the transaction of business."

The text Michie's Jurisprudence of Virginia and West Virginia, Corporations, § 170, states: "A quorum is necessary [to transact the corporation's business] except where a director disqualified on account of interest is required to withdraw. The mere presence of a majority of the board of directors constitutes a quorum, whether all of them vote on a question or not. Thus, where the directors of a corporation have the power to bind it by their contracts, the majority of the directors may so bind it, whether those voting are a quorum or not, provided a quorum is present. "In the absence of express authority a minority of the board of directors of a corporation cannot legally transact business, and in such cases the acts of a minority are not voidable only, but are void." (Footnotes omitted)

Pursuant to Michie's and the cases cited there and especially to *Stewart v. Lady* (1996) 251 Va. 106, 110; 465 S.E.2d 782, *Blue Ridge Property Owners v. Miller* 216 Va. 611, 613, 221 S.E.2d 163 (1976), *Lewis v. Glenn* 84 Va. 947, 870-871, 6 S.E. 866 (1888), Virginia Code §§ 13.1-803, 13.1-855(D) and 13.1-857(B), it is clear that Mr. Gibson and Mr. Drewer continued in office as directors until their successors were appointed. Because there is no record that Richard Kennedy, Jr. was appointed to the directorship by a Charter Member, it follows that he is not and never was a legitimate director. Therefore, the three directors were in office as of November 1, 2000 were Richard Kennedy, Sr., Mr. Gibson and Mr. Drewer. Therefore, a quorum is not less than two directors and a majority of the directors then in office is also two.

Since the amendment to the bylaws was signed by only Mr. Kennedy, Sr., it appears on its face to have been done without a quorum being present and without being approved by a majority of the directors then in office.

In addition, an amendment to the bylaws or the charter of a corporation can only be valid if it is passed in accordance to the original, unamended bylaws or charter. In the case of *Oberly v. Howard Hughes Medical Institute* (Del. Ch. 1984) 472 A.2d 366, the Court was called upon to decide if amendments to the Institute's bylaws were valid. The Institute's original charter provided that only the Trustee could adopt or amend bylaws. When a bylaw permitting the Institute's "Executive Committee" (the functional equivalent of a board of directors) exercise the powers of the Trustee "in the absence of a Trustee" was passed without the Trustee's (that is, Howard R. Hughes') express approval and the Executive Committee attempted to amend and restate its certificate of incorporation pursuant to this bylaw, the Chancellor ruled the Executive Committee's actions were "void and of no effect due to the lack of any power and authority in the Executive Committee to bring about such an amendment." *Id.* at 392. Here, NFH's rump board of directors (that is, Mr. Kennedy) has attempted to amend the Bylaws and the Charter

THE LAW OFFICE OF RICHARD A. MCFARLANE

Redacted

August 7, 2003

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without the power and authority to do so.

In the case *Oberly v. Kirby*, (Del 1991) 592 A.2d 445, disgruntled members of the foundation's board of directors attempted to amend the foundation's bylaws to make themselves members of the foundation. The Delaware Supreme Court ruled, "We do not believe that the Foundation's members can be ousted by the very directors whom they have elected. Any other interpretation would render the Foundation's corporate structure fundamentally unstable." *Id.* at 459. The Court continued, "[The directors'] proposed amendment is invalid not primarily because it violates Delaware law, but because it is contrary to the Foundation's Certificate. It violates Delaware law only because it is contrary to the Certificate." *Id.* Here, NFH's rump board of directors (that is, Mr. Kennedy) has attempted to do the same as directors in *Kirby*, and for the same reasons it should not be allowed.

The amendment to NFH's bylaws is invalid because it was adopted without a quorum being present and alters the Charter without following the original charter's provisions.

4. Alter ego

The final issue is whether Richard Kennedy's actions have made NFH an alter ego of himself. The facts supporting this issue still need to be developed. Discovery is underway in the other litigation between NFH and ADC and between NFH and other parties. We are on friendly terms with these parties and their counsel. At this time, we know that NFH's record keeping is sloppy, at best, and that corporate formalities have not been followed. *See Board of Directors of the Port Royal Condominium Unit Owners' Association v. Crossland Savings F.S.B.* (Va. Ch. 1991) 23 Va. Cir. 4. For example, Mr. Gibson's alleged resignation was never followed up.

In the case *Cheatle, et al. v. Rudd's Swimming Pool Supply Co., Inc.* (1987) 234 Va. 207, 212-213; 360 S.E.2d 828., the Virginia Supreme Court ruled, "A decision whether to disregard the corporate fiction depends largely upon resolution of questions of fact with the burden of proof resting upon the party seeking to pierce the veil. Pertinent to this case, the plaintiff must show that the corporate entity was the alter ego, alias, stooge, or dummy of the individuals sought to be charged personally and that the corporation was a device or sham used to disguise wrongs, obscure fraud, or conceal crime. *Lewis Trucking Corp. v. Commonwealth*, 207 Va. 23, 31, 147 S.E.2d 747, 753 (1966). A trial court's ruling on such questions will be regarded as presumptively correct and will not be overturned on appeal unless clearly erroneous."

In the earlier case of *Beale v. Kappa Alpha Order* (1951) 192 Va. 382; 64 S.E.2d 789, the Virginia Supreme Court applied the general rules of piercing the corporate veil to nonprofit corporations. "Just when a corporation will be regarded as the adjunct, creature, instrumentality, device, stooge, or dummy of another corporation is usually held to be a question of fact in each case. As above stated the general rule is that the separate corporate entity of corporations will be observed by the courts, even though one may dominate or control another, or may treat it as a

THE LAW OFFICE OF RICHARD A. MCFARLANE

Redacted  
August 7, 2003

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mere department, instrumentality, agency, etc.; and courts will disregard the separate legal identities of the corporation only when one is used to defeat public convenience, justify wrongs, protect fraud or crime of the other.' State v. Swift & Co. (Tex. Civ. App.), 187 S.W.2d 127, 133."

I think the law supports the position that Mr. Kennedy and Mr. Mason have become the alter ego of NFH. I would value your opinion.

5. Conclusion

My client's objective is to remove Richard Kennedy and Ted Mason and Maxus Development from any position with NFH. I believe that my clients have standing to bring an action in Chancery Court for equitable relief. I believe the facts of the case and the law will support such a finding.

Very truly yours,

The Law Office of Richard A. McFarlane

Richard A. McFarlane