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BUSINESS ASSOCIATIONS—1958 TENNESSEE SURVEY

F. HODGE O'NEAL*

Only a handful of cases were decided in Tennessee during the survey period which raised questions in the field of business associations. Some of the issues raised in these cases, however, were of considerable interest and importance.

Power of Minority Shareholders in Close Corporation to Obtain an Accounting: The most interesting and perhaps the most important Tennessee decision on a corporation question was *Akin v. Mackie*[1] decided by the Supreme Court of Tennessee. In that case, complainants sought a discovery and an accounting from defendant, the corporation's president, treasurer and majority shareholder. The two complainants together owned 49 per cent of the corporation's stock, and defendant owned the remaining 51 per cent. Complainants and defendant constituted the membership of the corporation's three-man board of directors. The bill alleged that from the time defendant acquired the controlling interest in the corporation he was secretive about its management, that no corporate books were kept after he acquired control, and that he had stated repeatedly that the business was fast becoming insolvent and should be adjudged bankrupt. The bill, however, expressly stated that complainants "impute no dishonesty" to defendant. Defendant demurred to the bill, the demurrer being interpreted by the court as based on the following grounds: (1) the bill did not name the corporation as a defendant, and (2) a minority shareholder cannot have an accounting without first exhausting his legal and equitable remedies against the corporation's directors by notice and formal request to them to correct what is believed to be a violation of their duties to the shareholders. The chancellor overruled the demurrer, and the supreme court affirmed the chancellor's decree. The supreme court stated that the "charges made in the bill that the defendant claimed to have kept no records of business transactions after he acquired control of a majority of the stock, and that the corporation was on the verge of bankruptcy all of which was admitted to be true by the demurrer" are sufficient grounds for maintaining the suit.[2]

A considerable part of the court's opinion was devoted to a discussion of the general rule, well established in Tennessee and elsewhere, that a bill cannot be maintained by a shareholder for the use of the

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1. 310 S.W.2d 164 (Tenn. 1958).
2. *Id.* at 168.

corporation if a majority of the board of directors is competent and qualified to act and no demand has been made on them to bring a proper suit, and of the equally well-established exception to that rule dispensing with the necessity for a demand upon corporate authorities if the demand would be useless and unavailing in that it would be refused or if granted the litigation would necessarily be under the control of persons opposed to its success.

The court held that the instant case was controlled by the exception rather than the rule. In this connection, it should be noted that the suit was not a shareholders' derivative action and that strictly speaking a discussion of the rule and its exception was not pertinent in this litigation, this being a suit by shareholders in their own behalf. Perhaps what the court had in mind was that the same policy and business considerations which support the rule requiring a shareholder to exhaust his corporate remedies before bringing a derivative action might with some logic be held to apply also to a suit by a minority shareholder against the majority shareholder and principal executive officer for a discovery and an accounting. But, if that was the thinking behind the court's discussion of the rule, it probably should have found that complainants had an adequate remedy within the corporation and dismissed complainants' bill for complainants constituted a majority of the corporation's board of directors. Assuming that the corporation's charter or by-laws did not contain a provision permitting the majority shareholder to remove board members without cause before the end of their term, complainants, if necessary, could have taken over the management of the corporation for the remainder of their term, removing defendant from his positions as president and treasurer.

Though the court's reasoning may be subject to criticism on technical grounds, the result that it reached is clearly a desirable one. In most close corporations, paper work is neglected and few if any corporate records are kept. There may be a fragmentary file of corporation minutes, but that file will often be limited to copies of a few resolutions required by the exigencies of business, such as resolutions required by banks for the opening of checking accounts and resolutions required for the passage of title to real property.[3] Not uncommonly the holders of a majority of the voting shares take complete control of the corporation, "run the show" themselves, appoint themselves or their nominees to corporate offices, drain off the corporation's earnings in salaries, and refuse to give minority shareholders any information at all about the corporation's affairs or how its business is being conducted. The minority shareholders' right to inspect the corporation's books and records is, as a practical matter, often useless, because there are no corporate books and records; and even where books and

3. See O'NEAL, CLOSE CORPORATIONS: LAW AND PRACTICE § 8.02 (1958).

records exist it is doubtful whether shareholders are privileged to inspect the corporation's property to determine whether the corporation's assets actually are accurately reflected on its books.[4] The court in the instant case gave minority shareholders who had been frozen out a very effective way of obtaining information about the corporation's affairs. In making its decision, the court emphasized that it was dealing with a corporation in which complainants and defendant owned all of the stock and constituted the full membership of the board of directors,[5] perhaps intimating that another result might have been called for if this had been a public issue corporation. In other words, the Supreme Court of Tennessee, just as courts in other jurisdictions, found that close corporations have characteristics and needs separate and distinct from those of public issue corporations and that the rules applicable to public issue corporations should not necessarily be applied to close corporations.

Disregarding Corporate Entity in Close Corporation: The close corporation, just as the public issue corporation, is generally viewed as a "legal entity" having in law an existence separate and apart from its shareholders. This means that rights, duties and other legal relations arising out of an incorporated enterprise, irrespective of whether it is widely held or closely held, are usually adjusted as though the corporation is a separate legal person. A corporation's separate legal personality is said not to be lost merely because all of its stock is held by two or three persons, by the members of a single family, or even by a single individual.[6]

In spite of this general adherence in theory to the notion that a corporation whether widely or closely held is a legal entity, the courts disregard a corporation's separate personality whenever they conclude that the corporate form is being employed to evade an obligation, to circumvent a statute, to perpetrate a fraud or crime, or to gain an unjust advantage or commit an injustice.[7] Apparently the courts are somewhat more ready to disregard a corporation's separate legal personality if it is closely held than if it is a public issue corporation.[8] Perhaps this readiness is due in part at least to the courts' awareness of the superior opportunity which shareholders' in a close corporation

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4. See BALLANTINE, CORPORATIONS § 164 (1946).

5. 310 S.W.2d at 167.

6. United States v. Weissman, 219 F.2d 837 (2d Cir. 1955); Commerce Trust Co. v. Woodbury, 77 F.2d 478, 487 (8th Cir. 1935); Ross v. Biggs, 206 Miss. 542, 40 So. 2d 293 (1949); Springborn v. Anita Land Co., 101 N.E.2d 238 (Ohio App. 1951).

7. See generally Annots., 1 A.L.R. 610 (1919), 34 A.L.R. 597 (1925).

8. See O'NEAL, CLOSE CORPORATIONS: LAW AND PRACTICE § 1.09 (1958); ROHRLICH, ORGANIZING CORPORATE AND OTHER BUSINESS ENTERPRISES § 4.11 n. 72 (rev. ed. 1953).

have to control corporate activities and manipulate corporate and individual assets to the detriment of creditors and other outsiders.

A recent decision of the United States Court of Appeals, Sixth Circuit, *Thoni Trucking Co. v. Foster*,[9] illustrates the way in which affairs of a close corporation are sometimes manipulated in an attempt to injure corporate creditors. In that case Thoni owned all except two of the corporation's shares, one share each being owned by Thoni's wife and father. The three-man board of directors was composed of Thoni and his wife and father. Shortly after Thoni learned of an accident in Illinois (involving one of the corporation's trucks) in which plaintiffs were injured, the board of directors took various steps which resulted in stripping the corporation of all its assets. Substantial sums were paid to Thoni in the guise of salaries and dividends, and the remaining assets and business operations of the corporation were transferred to another company owned by Thoni. Further, Thoni caused misleading correspondence to be sent to plaintiffs, first directing them to seek recovery from the corporation and later advising them that the corporation was no longer operating and had no substantial assets. Plaintiffs, after recovering default judgments in a state court in Illinois, brought suit in the Federal District Court for the Middle District of Tennessee; and the district court held Thoni personally liable for the amount of the Illinois judgments. On appeal, the court of appeals affirmed, declaring that Thoni had utilized his position of dominance and control over the corporation for the fraudulent purpose of depriving plaintiffs of their rightful recovery, and holding that in this situation Tennessee law provides that the corporate entity may be disregarded.[10]

Legality of Bank's Lending Money to County School Board of Which Its President is a Member: The Tennessee Code[11] provides that it shall be unlawful "for any officer, committeeman, director, or person whose duty it is to vote for, let out, overlook, or in any manner to superintend, any work of any contract in which any municipal corporation, county, or the state, shall or may be interested, to be directly or indirectly interested" in the contract. In *State v. Yoakum*,[12] decided by the Court of Appeals of Tennessee, Eastern Section, the Claiborne County Bank, in which defendant owned controlling stock and of

9. 243 F.2d 570 (6th Cir. 1957).

10. Another recent federal court decision which may be of some interest to Tennessee lawyers with a corporate practice is City of Nashville v. United States, 155 F. Supp. 98 (M.D. Tenn. 1957), in which the court laid down among others the following conclusion of law: the Interstate Commerce Commission is empowered to authorize the merger of two or more railroads without regard to the provisions of the laws of any state, except that state law (if any) may govern the size of the stockholder vote required for approval of a merger.

11. Tenn. Code Ann. § 12-401 (1956).

12. 306 S.W.2d 39 (Tenn. App. E.S. 1957).

which he was president, loaned the school board the sum of $7,500. The loan was repaid with interest. The chancellor found that the loan was made in good faith as an accommodation to the school board and not for profit, but held that in making the loan the defendant entered into a contractual relationship prohibited by the statute. The court of appeals reversed the chancellor. After commenting that the proceeds of the loan were placed on deposit in the bank and checked out on a large number of checks the handling costs of which exceeded the interest collected, the court held that a loan made in good faith for a legitimate purpose at the legal rate of interest does not violate the policy and purpose of the statute.

Quorum and Vote Requirements in General Welfare Corporations: The Tennessee Code Annotated, title 48, chapter 11[13] provides for the organization and operation of general welfare corporations, *i.e.*, corporations organized "for the general welfare of society" and not for individual profit. *Bedford County Hospital v. County of Bedford,*[14] a recent decision of the Court of Appeals of Tennessee, Middle Section, interprets some of the sections in this chapter of the code and lays down rules on quorum and vote requirements for general welfare corporations. The *Bedford County Hospital* decision is discussed here, even though this article deals with business associations, because: (1) a hospital, even when it is operated without a view to private profit, is in a sense a business organization or at least its methods of operation are quite similar to those of some business organizations; (2) the court in its opinion expressly stated that members in a welfare corporation "hold in the nature of stockholders in a private corporation";[15] and (3) what the court said here in interpreting the welfare corporation statute and in laying down rules for welfare corporations may sometimes in the future throw light on what action the court will take on questions involving private business corporations.

In the *Bedford County Hospital* case a welfare corporation organized to operate a hospital brought a suit against Bedford County to cancel a deed by which the corporation's assets had been transferred to the county. The validity of the deed depended on the effect to be given action authorizing the deed taken by a group which purported to be the corporation's board of directors. The first corporation question considered (a number of procedural questions and questions involving jurisdiction of the chancery court were discussed first) was the validity of a meeting of the corporation's members at which the members had supposedly elected a board and authorized the execution of the deed. Construing together two sections of the statutes dealing with

13. TENN. CODE ANN. §§ 48-1101, -1121 (1956).
14. 304 S.W.2d 697 (Tenn. App. M.S. 1957).
15. *Id.* at 700.

welfare corporations,[16] the court concluded that the presence of the holders of a majority of all voting power (voting power being calculated on the basis of one vote for each $100 contributed to corporate capital, as provided in the corporation's charter)[17] was necessary to constitute a quorum,[18] and that therefore action taken at the members' meeting was void for lack of a quorum.

The second corporation question considered by the court was whether the group of persons claiming to be the board of directors had the power to execute and deliver the deed. The court decided that directors did not have that power, because: (1) a majority of the members of the alleged board were not members of the corporation, and the corporation's charter required that directors be members; (2) at the time of the directors' resolution purporting to authorize the deeding of the property, the total assets of a welfare corporation could legally be transferred only to another welfare corporation, and the county therefore was not qualified to receive the assets; and (3) in any event (though the court admitted this holding was not necessary to its decision) the board of directors in authorizing the deed exceeded the authority which had been conferred on it by the members.

Duty of Electric Membership Corporation to Furnish Services: Another case involving a special type of corporation was *Chumbley v. Duck River Electric Membership Corp.*,[19] decided by the Supreme Court of Tennessee. In that case the complainant filed a bill to compel defendant to install electricity on complainant's property, on the theory that defendant is a public service corporation and is under obligation to furnish facilities to all inhabitants without discrimination. Defendant demurred on the ground that the bill alleged no fact showing defendant to be subject to an obligation to furnish facilities. The chancellor sustained the demurrer, and the supreme court affirmed. The reasoning was as follows: if (under the allegation of the bill) defendant is considered a public utility or public service corporation, defendant is not under a duty to extend its facilities unless and

16. TENN. CODE ANN. §§ 48-1114, 48-1120 (1956).

17. This method of calculation was approved in spite of TENN. CODE ANN. § 48-1114 (1956), which provides in part that in elections each member is "to be entitled to one (1) vote, either in person or by proxy, and the result to be determined by a majority of the votes cast."

18. The rule applicable to business corporations is that in the absence of express provision to the contrary in a statute or in a charter or by-law provision, any number of shareholders who may be present, provided there are at least two (and assuming notice of the meeting has been given where required), constitutes a quorum for the transaction of business by the shareholders. Of course, by an express statutory provision or by charter or by-law clause the quorum can be raised so as to require the presence of a majority of the shareholders or of the holders of a majority of the voting power. See BALLANTINE, CORPORATIONS § 173 (1946).

19. 310 S.W.2d 453 (Tenn. 1958).

until ordered to do so by the Tennessee Public Service Commission, in which exclusive jurisdiction over this kind of question is exclusively vested in the first instance; on the other hand, if (because defendant is sued under the name and style of an electric membership corporation) the court were to take judicial notice of the fact that defendant is an electric membership corporation, defendant is not under a duty to extend its facilities to complainant, because complainant does not aver that he is a member of the corporation or that he has complied with the reasonable rules and regulations and has become entitled to the privileges of membership.

Joint Ownership of Property and the Sharing of Gross Returns as Indication of Partnership: The only case decided in Tennessee during the survey period which raised a question of partnership law was *Mullins v. Evans*,[20] decided by the Court of Appeals of Tennessee, Eastern Section. In that case a number of landowners entered into a pooling agreement by which they conveyed unmined coal on their properties to a trustee to facilitate the lease of the properties as a unit for coal mining. The principal question in the case was whether royalties for the mining of coal, accruing after the death of one of the landowners, passed as realty to her heirs at law or as personalty to her surviving husband. One of the arguments advanced by the husband was that the execution of the trust instrument by his landowning wife and the subsequent execution of a lease by the trustee effected an equitable conversion of the wife's interest from realty to personalty and that she had only an interest in a mining partnership which descended as personalty to him as surviving husband. The court held that the creation of the trust did not effect a conversion of the landowner's interest from realty to personalty. As to the partnership question, the court pointed out that under the Uniform Partnership Act applicable in Tennessee[21] the joint ownership of property or the sharing of gross returns "whether or not the person sharing them have a joint or common right or interest in any property from which the returns are derived" does not of itself establish a partnership.[22] As the court could find no other circumstance supporting a partnership, and as the burden of proof was on the party alleging a partnership, the court held that the husband had not established his right to receive the royalties.

20. 308 S.W.2d 494 (Tenn. App. E.S. 1957).
21. TENN. CODE ANN. § 61-106 (1956).
22. 308 S.W.2d at 498.