Vanderbilt Law Review

Volume 18
Issue 3 *Issue 3 - June 1965*

Article 9

6-1965

Business Associations–1964 Tennessee Survey

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In *Denny v. Phillips & Buttorff Corp.*,[1] the United States Court of Appeals for the Sixth Circuit affirmed a judgment of the United States Court for the Middle District of Tennessee which awarded $235,000 in fees plus $6,227.98 in expenses to counsel representing minority stockholders in a suit which had been brought to force cancellation of a purchase by the Phillips & Buttorff Corp. from the instrumentalities of the controlling stockholders of such corporation of 60,000 shares of stock in Wm. R. Moore Dry Goods Company for $2,700,000. The purchase of the Moore stock had apparently been used as a means by which the controlling group in the Phillips corporation had obtained corporate funds with which to finance their acquisition of a controlling amount of stock.[2]

Although the purchase of the Moore stock was rescinded before the derivative action was tried, the court in a former opinion[3] described the purchase transaction as constructive fraud[4] and ordered judgment to be rendered on behalf of the corporation against the offending directors in an amount equal to interest on the $2,700,000 purchase price from the date of commencement of the action until recission.[5] The description, by the court of appeals, of the stock purchase transaction as constructive fraud is not readily reconcilable with an apparent finding of the district court that the purchase price paid by the corporation for the Moore stock was not unfair. The latter finding raises the questions of the extent to which the corporation was harmed by the "constructive fraud" and the extent to which the corporation was benefited by the rescission of the constructively fraudulent transaction. Although the court of appeals, in its former opinion, did not set aside the district court's finding as to value, it did find prejudice to the corporation which resulted from the directors "stripping . . . [the corporation] of its cash and marketable securities and

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1. 331 F.2d 249 (6th Cir.), *cert. denied*, 379 U.S. 831 (1964).
2. See the description of the transaction in Maggiore v. Bradford, 310 F.2d 519, 520 (6th Cir. 1962), *cert. denied*, 372 U.S. 934 (1963). See also a discussion of such transaction and of the *Maggiore* case in Covington, *Business Associations—1963 Tennessee Survey*, 17 VAND. L. REV. 923, 925-27 (1964).
3. Maggiore v. Bradford, *supra* note 2.
4. *Id.* at 521. The court also stated that, "stripping P & B of its cash and marketable securities so that the Comer Group could finance their controlling shares certainly operated to the prejudice of P & B and its minority shareholders." *Ibid.*
5. *Id.* at 522. The rationale for awarding interest from the date of the commencement of suit could have been the treatment of the stock purchase as a voidable transaction and the commencement of suit for recission as a disaffirmance of such voidable transaction and an offer to return the Moore stock. *But see* Dale v. Thomas H. Temple Co., 186 Tenn. 69, 208 S.W.2d 344 (1948), cited by the court in connection with its interest computation.

requiring it to borrow money so that the Comer Group could finance their controlling shares . . . ."[6]

In the instant opinion the court felt that the large attorney's fees were proper, despite the fact that the judgment for interest[7] on $2,700,000 from the commencement of the action until rescission bore no relation to the amount of the fees awarded, because the court felt the cancellation of the stock purchase was the result of the commencement of the stockholder's derivative action.[8] The court felt that the cancellation of the stock purchase "inured to the benefit of the corporation by restoring $2,700,000 in assets in lieu of the Moore Stock,"[9] but the opinion made no reference to the worth of the Moore stock of which the corporation had possession between the purchase and the recission.

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6. See 310 F.2d at 521: "The District Judge . . . found that the price paid for the Moore shares was not unfair or oppressive either to P & B or its minority shareholders."

7. Interest on the $2,700,000 was adjudged to be $40,800. See 331 F.2d at 250.

8. 331 F.2d at 251. The court stated with respect to the causal connection between the bringing of the derivative action and the cancellation of the stock purchase that: "It cannot be said that the cancellation of the purchase of the Moore stock did not result from the action of the minority stockholders." *Ibid.; cf.* Ripley v. International Rys. of Cent. America, 16 App. Div. 2d 260, 264, 227 N.Y.S.2d 64, 69, aff'd, 12 N.Y.2d 814, 187 N.E.2d 131 (1962) ("Beneficial acts performed by the corporation —if the result, in the whole or in substantial part, is attributable to the stockholders' litigation—may be a valid base to claim compensation.").

9. In many derivative suits, fees have been awarded to plaintiff's counsel upon a theory of a "benefit" received by the corporation through the efforts of such counsel. See Grant v. Lookout Mt. Co., 93 Tenn. 691, 28 S.W. 90 (1894). Where the successful plaintiff's counsel has prevented the dissipation of corporate property or where he has obtained a monetary judgment in favor of the corporation, the economic benefit to the corporation may be measurable. Accordingly, the corporate beneficiary of a measurable economic benefit can be assessed a sum for the legal services expended on achieving that benefit on a quasi-contractual theory. See Hornstein, *The Counsel Fee in Stockholder's Derivative Suits*, 39 Colum. L. Rev. 784, 789 (1939); *cf.* Whitsett v. City Bldg. & Loan Ass'n, 3 Tenn. Ch. 526 (1877). In such instances, it is not uncommon for a court to refer to the property obtained or recovered or protected as a "fund" out of which counsel fees can be awarded. The presence of such a "fund," it will be noted, can facilitate the fee award bearing a reasonable relation to the corporate benefit received. *E.g.*, Uffelman v. Boillin, 19 Tenn. App. 1, 43, 82 S.W.2d 545, 570 (M.S. 1935) (fee payable to successful counsel in stockholders' suit "out of the aggregate recovery"). Compare Pennington v. Divney, 182 Tenn. 207, 185 S.W.2d 514 (1945) (applying a "benefit" rationale to fees awarded counsel of a creditor). *But see* Hornstein, *supra*, at 799 n.100 (describing cases in which fee awards exceeded economic benefits to the corporation).

The relationship of the benefit to such a fund is absent in cases in which the efforts of counsel for minority stockholders, although successful, has not resulted in a measurable economic benefit to the corporation. In such instances, however, some courts have nonetheless awarded attorneys' fees on the ground that the corporation or a class of stockholders was benefited, although not in economic terms. Richman v. DeVal Aerodynamics, Inc., 40 Del. Ch. 548, 185 A.2d 884 (1962); *cf.* Gilbert v. Local 701, Hoisting & Portable Eng., 237 Ore. 130, 384 P.2d 136 (1963), *cert. denied*, 376 U.S. 963 (1964); Note, 48 Calif. L. Rev. 843 (1960). To the extent that fees are awarded where the corporate benefit is not economically measurable, the emphasis in determining the size of the fees awarded may be based upon the effort of the attorney and the value of his time. Nonetheless, those courts which, as a condition of awarding

Although the amount of counsel fees approved in the instant case would seem not excessive[10] if the corporation had benefited[10a] by $2,700,000 an appraisal of the benefit to the corporation based upon the difference between the purchase price recovered and the Moore stock surrendered might make the amount of the counsel fees less easily justified.[11] The court apparently felt that the financing of an acquisition of controlling stock with corporate funds derived from a sale to the corporation of the stock of another corporation is so inherently suspect that the counsel fees awarded to minority stockholder counsel in voiding such a transaction ought to be based not on a calculation of economic benefit to the corporation, but upon a determination of the value of time and effort expended by counsel reasonably related to securing the invalidation of such a transaction. Why the minority stockholders should be forced to pay for legal services in excess of the benefit to them was unexplained.

Davis v. Appalachian Electric Co-op.,[12] determined that before members

attorney's fees, have insisted upon a benefit to the corporation which is "substantial" in a meaningful sense may be retaining some notion of a relation between the benefit received and the fees awarded. Richman v. DeVal Aerodynamics, Inc., *supra*, *cf.* Berger v. Amana Soe'y, 253 Iowa 378, 111 N.W.2d 753 (1961); Bosch v. Meeker Co-op. Light & Power Ass'n, 257 Minn. 362, 101 N.W.2d 423 (1960).

The benefit rationale of the awarding of fees has been re-enforced in some cases with a rationale of preventing corporate wrongdoing. Fee awards, it is said, will discourage corporate managers from wrongdoing by making easier the bringing of corrective derivative suits. See, *e.g.*, Bosch v. Meeker Co-op. Light & Power Ass'n, *supra*. To the extent that this policy rationale is intended to discourage breaches of trust by controlling shareholders, as distinguished from discouraging law violations generally, *compare* Abrams v. Textile Realty Corp., 97 N.Y.S.2d 492 (Sup. Ct. 1949), *with* Schechtman v. Wolfson, 244 F.2d 537 (2d Cir. 1957), the attorney's fees awarded ought not to be so large as to outweigh the benefits accruing to the corporation from the suit. *Cf.* Eisenberg v. Central Zone Prop. Corp., 1 App. Div. 2d 353, 149 N.Y.S.2d 840 (1956), *aff'd mem.*, 3 N.Y.2d 729, 143 N.E.2d 516, *cert. denied*, 355 U.S. 884 (1957). *Accord*, Note, 45 MINN. L. REV. 164, 167-68. (1960). *But cf.* Note, 13 STAN. L. REV. 146 (1960).

10. Compare the counsel fee awards and their relation to the size of judgments recovered by corporations presented in tabular form in Hornstein, *New Aspects of Stockholders' Derivative Suits*, 47 COLUM. L. REV. 1, 15-17 (1947). See 13 FLETCHER, PRIVATE CORPORATIONS § 6045 (perm. ed. rev. 1961). Hornstein, *Problems of Procedure in Stockholder's Derivative Suits*, 42 COLUM. L. REV. 574, 587 (1942); Hornstein, *The Counsel Fee in Stockholder Derivative Suits*, *supra*, note 9, at 814; see also Hornstein, *Legal Therapeutics: The "Salvage" Factor in Counsel Fee Awards*, 69 HARV. L. REV. 658 (1956).

10a. In other situations related to attorneys' claims, the relevance of a benefit to the client seems to vary. Thus an attorney's lien for his fees seems to be recognized only when there has been an affirmative recovery and not when property has been merely successfully defended. John Weis, Inc. v. Reid, 22 Tenn. App. 90, 118 S.W.2d 677 (M.S. 1938). Although when third persons are involved policy reasons partly explain the foregoing distinction, *cf.* Garner v. Garner, 69 Tenn. 29 (1878), affirmative "benefit" to a client seems to circumscribe the extent of the attorney's lien, while no lien exists despite the actual benefit which results from the protection of valuable property. On the other hand, the courts have expressly held that recovery of an attorney's fee on a quantum meruit basis is not limited by the "benefit" of the attorney's services to the client. Bills v. Polk, 72 Tenn. 494, 496 (1880).

11. See note 6 *supra* and accompanying text.

12. 373 S.W.2d 450 (Tenn. 1963).

of an electric cooperative chartered under the Electric Cooperative Law[13] could maintain an action against the cooperative to compel the distribution of cooperative revenues in excess of the amounts authorized under the Electric Cooperative Law to be retained,[14] the complaining members must first exhaust their remedies within the cooperative.[15] It would appear that the requirement of exhaustion was properly applied in the instant case. Although the statute expressly commands the distribution of revenues in excess of amounts specifically authorized therein to be retained,[16] and to that extent in form removes the power of decision with respect to revenue accumulation from the board of trustees,[17] the statute both

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13. TENN. CODE ANN. §§ 65-2501 to -2533 (1955).

14. TENN. CODE ANN. § 65-2516 provides as follows:

"Refunds to members.—Revenues of a cooperative for any fiscal year, in excess of the amount thereof necessary:

(A) To defray expenses of the cooperative and of the operation and maintenance of its facilities during such fiscal year;

(B) To pay interest and principal obligations of the cooperative coming due in such fiscal year;

(C) To finance, or to provide a reserve for the financing of, the construction or acquisition by the cooperative of additional facilities to the extent determined by the board of trustees;

(D) To provide a reasonable reserve for working capital;

(E) To provide a reserve for the payment of indebtedness of the cooperative maturing more than one (1) year after the date of the incurrence of such indebtedness in an amount not less than the total of the interest and principal payments in respect thereof required to be made during the next following fiscal year; and

(F) To provide a fund for education in cooperation and for the dissemination of information concerning the effective use of electric energy and other services made available by the cooperative, shall be distributed by the cooperative to its members as, and in the manner, provided in the by-laws, either (1) as patronage refunds prorated in accordance with the patronage of the cooperative by the respective members paid for during such fiscal year, or (2) by way of general rate reductions, or (3) by combination of such methods. Nothing herein contained shall be construed to prohibit the payment by a cooperative of all or any part of its indebtedness prior to the date when the same shall become due."

It will be noted that although the quoted section is phrased in mandatory terms in connection with the distribution of excess revenues, the section embodies trustee judgment in the determination of the amounts authorized to be retained, and thereby in the determination of the amount of revenues which are in "excess" of the amounts authorized to be retained.

15. The opinion of the court written by Justice White relied on a general practice of courts in requiring exhaustion of corporate remedies before judicial remedies will be invoked. In his concurring opinion, Justice Dyer set forth additional reasons for requiring exhaustion in the instant case which were based upon provisions of the Electric Cooperative Law and the bylaws of the cooperative. Of particular interest is Justice Dyer's invocation of § 65-2524 which permits 10% of the membership to place a proposition before the entire membership at a special meeting. After invoking that provision as a possible method by which the complainants in the instant case could obtain a remedy within the cooperative, Justice Dyer then casts doubt on the availability of such a remedy by expressly raising the possibility that the Legislature did not intend the section to be invoked with respect to an issue such as the retention or distribution of revenues. 373 S.W.2d at 455.

16. TENN. CODE ANN. § 65-2516 (1955). See note 14 *supra*.

17. The possession of a power of decision has often been the rationale of the exhaustion requirement. Especially in derivative suits where the directors have a power

expressly[18] and by necessary implication[19] invokes the judgment and discretion of the board of trustees in the determination of the amounts which the statute authorizes to be retained. Thus, the statute expressly vests the board with power to determine the sums required to be retained for expansion[20] and impliedly vests the board with power to determine the size of the working capital reserve,[21] the indebtedness repayment reserve,[22] and an information-dissemination reserve.[23] Since the statute necessarily assumes the exercise of the judgment of the board of trustees in its application, the court would have been both unwise and in error to have undertaken to decide what amounts should be distributed until the trustees were notified of the complaint of the objecting members and were given an opportunity to exercise that judgment. This opportunity might satisfy the complaining members and end the litigation,[24] or, especially if the trustees state their reasons for failing to comply with the objecting members' demands,[25] as it would normally be desirable for the trustees

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to decide whether the interests of the corporation would be furthered by suit, the requirement of an initial demand upon the directors is designed to cause the directors to exercise the power and discretion with which they have been invested. In cases where the directors would not possess a disinterested judgment because of director interest, the law usually excuses the suing stockholder from the initial demand upon the director.

18. TENN. CODE ANN. § 65-2516(C) (1955). In clause (C) the board is expressly vested with discretion to determine the amounts to finance or reserve for the financing of expansion.

19. TENN. CODE ANN. § 65-2516(D),(E), & (F) (1955). Thus, the board would have to determine what was a "reasonable" reserve for working capital under clause (D). The board would have to determine the size of the reserve for repayment of indebtedness under clause (E) where the statute governs only to the extent of declaring a minimum reserve. Furthermore, in clause (F) the statute expressly authorizes repayment of indebtedness prior to maturity and accordingly seems to vest the trustees with discretion to withhold profits for that purpose. The board would also apparently have discretion to determine the size of the information dissemination fund authorized by clause (F).

20. TENN. CODE ANN. § 65-2516(C) (1955).

21. TENN. CODE ANN. § 65-2516 (1955). In its authorization of a "reasonable" working capital reserve, the statute would seem to invoke the judgment of the board of trustees at least in the first instance as to the determination of reasonableness. It is possible that the act might permit the by-laws to embody standards of reasonableness, however, and thus limit to some extent the scope for trustee judgment. *Compare* § 65-2509 (by-laws), *with* § 65-2510 providing that "the business and affairs of a cooperative shall be managed by a board of . . . trustees." *Cf.* 373 S.W.2d at 454 (concurring opinion).

22. TENN. CODE ANN. § 65-2516(E),(F) (1955). Clause (E) authorizes an indebtedness repayment reserve but contains no guidelines with respect to the size of such reserve apart from establishing its minimum size, and clause (F) expressly permits repayment of indebtedness before maturity, thus re-emphasizing that the standard contained in clause (E) is merely a minimum standard.

23. TENN. CODE ANN. § 65-2516(F) (1955).

24. This is the traditional reason for requiring exhaustion in derivative suits. Compare the analogous concept of exhaustion in administrative law.

25. Reasons are often helpful in evaluating the propriety of conduct. In many areas of law conduct may be lawful if done for one reason, but unlawful if done for a different reason. *But see* note 26 *infra*.

to do,[26] it may serve to narrow the issues[27] with respect to the justification for the retention of accumulated revenues.

The instant case does raise the broader question of the interrelation of the courts to the internal activities of an electric cooperative and of whether the relationship between the courts and business corporations ought to be carried over to cooperatives for all purposes.[28] Of course, courts are prone to decide cases by analogy, even when the analogy is one of language or concept rather than underlying legislative purposes.[29] The court was silent with respect to whether the policies embodied in the provisions of the Electric Cooperative Law distinguish institutions created by that law from those created pursuant to the business corporation statute by calling for a greater degree of judicial intervention on behalf of the membership. Justice Dyer addressed himself somewhat more to this point than did the opinion of the court, by pointing out various provisions of the Electric Cooperative Law which seem to suggest less rather than more judicial intervention in the workings of an electric cooperative because of the greater number and kind of internal remedies provided by such an institution.[30] It is not clear, however, that the greater availability of internal remedies may be but one facet of a legislative concern with a high degree of protection for the membership, and, accordingly, judicial intervention perhaps ought to occur whenever the court concludes that such intervention would be necessary to correct a situation which internal remedies in the particular situation are not well designed to correct. Furthermore, it is not clear to what extent the internal remedies provided by statutes may be reduced in effectiveness by the determined opposition of the board of trustees by making recommendations to the membership,[31] and by the distribution of literature to the membership justifying its own

26. Although it would be desirable to obtain the bases for the trustee's determination, caution must be utilized in imposing a requirement of rational explanation on businessmen who may intuitively approach business decisions and yet are unable to articulate their basis for decision. In such a case, the demonstrable invalidity of a businessman's reasons might not necessarily indicate that the action he thereby sought to justify was improper.

27. The issues might also be narrowed through the pleading and pre-trial process.

28. The opinion of the court seemed to assume that the present action ought to be dealt with in the same way as if it involved a complaint by some stockholders against a business corporation. *Cf.* FLETCHER, *op. cit. supra* note 10, § 8286.

29. *Cf.* NLRB v. Hearst Publications, Inc., 322 U.S. 111 (1944) (Frankfurter, J.).

30. Justice Dyer referred to § 65-2509 providing for membership control of by-laws. That section provides that the "By-laws shall set forth the rights and duties of members and trustees and may contain other provisions for the regulation and management of the affairs of the cooperative not inconsistent with this chapter or with the articles of incorporation." Section 65-2509 apparently modifies to some extent the provisions of § 65-2510 which vests management of the cooperative's "business and affairs" in the board of trustees. Justice Dyer also referred to § 65-2514 providing for membership meetings including provision for the initiation of membership meetings by 10% of the members and to § 65-2524 providing for submission of propositions to vote of the membership by petitions of 10% of such membership. *But see* note 4 *supra.*

31. Since each member has but one vote, under § 65-2514(G), the power of an entrenched board may be difficult to challenge.

position without distributing the literature of an opposition group.[32]

In the case of *In re Leeds Homes, Inc.*,[33] the United States Court of Appeals for the Sixth Circuit affirmed the judgment of the United States Court for the Eastern District of Tennessee in which the district court had allowed, under chapter 10[34] of the Bankruptcy Act in the reorganization of Leeds Homes, Inc., a Tennessee corporation, a claim as a secured creditor,[35] asserted by National Acceptance Company, a foreign corporation. The trustee in bankruptcy had opposed the claim on the ground that the creditor foreign corporation had been doing business in Tennessee without qualifying to do such business under Tennessee law, and that, accordingly, under Tennessee law the claim of such corporation would be barred under the policies embodied in sections 48-901 to -906 of the Tennessee Code Annotated.

The court held that state and federal law were both relevant in deciding the question. The court stated that the state law was relevant in determining whether or not an unqualified foreign corporation doing business in Tennessee had a claim, and then held that if state law acknowledged the existence of a claim—even if unenforceable[36]—then federal law[37] would be applied to determine whether that claim would be allowed in the bankruptcy proceeding. The court then reviewed the Tennessee decisions with respect to whether a contract entered into by an unqualified foreign corporation was void or voidable and found the language of such decisions inconsistent. It concluded, however, principally[38]

32. In connection with the statutory provision for propositions initiated by petition of 10% of the membership, the statute appears to require that "any document submitted with such petition to give effect to the proposition" shall be submitted to the members at a special or annual meeting. TENN. CODE ANN. § 65-2524 (1955). It does not require the distribution of such supporting document to the members prior to the meeting. Since a quorum exists if 2% of the members are present, as stated in § 65-2514(F), most of the members may never see the documents distributed in connection with a proposition initiated by 10% of the membership. Furthermore, it seems impossible for material distributed at a meeting to affect the thinking of a member who is present only by proxy or who votes by mail. See TENN. CODE ANN. § 65-2514(G) (1955).

33. 332 F.2d 648 (6th Cir. 1964), *affirming* 222 F. Supp. 20 (E.D. Tenn. 1964).

34. Bankruptcy Act, 52 Stat. 883 (1938), 11 U.S.C. §§ 501-676 (1958).

35. In the instant case the attack on the claim of the foreign corporation's creditor status seems to have encompassed both that corporation's rights to security and its claim for the excess above its security in bankruptcy proceedings. The court seems not to have finally determined the rights to the foreign corporation's status to the lien or security interest which it asserted (to which choice of law issues somewhat analogous to those involved in the allowance of the claim and discussed in the text might be relevant) but merely to have determined that its claims in excess of the realizable value of the security were not to be barred solely because of its failure to qualify as a foreign corporation.

36. 332 F.2d at 650.

37. *Ibid.*

38. The court cited in support of its conclusions Lloyd Thomas Co. v. Grosvenor, 144 Tenn. 347, 233 S.W. 669 (1921); Biggs v. Reliance Life Ins. Co., 137 Tenn. 598, 189 S.W. 174 (1917); Cunnyngham v. Shelby, 136 Tenn. 176, 188 S.W. 1147 (1916); Singer Mfg. Co. v. Draper, 103 Tenn. 262, 52 S.W. 879 (1899). The *Biggs* case treated the question of whether the contracts of unqualified foreign corporations are void or voidable only in dictum.

on the basis of *Singer Manufacturing Co. v. Draper*,[39] that such contracts would be considered voidable because they could be enforced against the foreign corporation, even though it could not enforce such contracts. The court then allowed the claim as a matter of federal law.[40]

In deciding to allow the claim of the foreign corporation as a matter of federal law, the court did not discuss the criteria which federal law would establish to determine the allowability of the claim. The court also chose not to discuss the relevance of section 70(c)[41] of the Bankruptcy Act which vests the trustee with "all defenses available to the bankrupt as against third persons." It is possible that in deciding to allow the claim if merely voidable, the present court thought that section 70(c) did not permit the voiding of contract under which the bankrupt estate had already received benefits.[42] Such an analysis does not take into account the unenforceability of the claim in the Tennessee courts despite the retention of benefits under the contract by the debtor. Possibly the enforceability of the claim outside of Tennessee was considered determinative by the court, since in applying section 70(c) the court may not be required to test the validity of the bankrupt's or the trustee's defenses by the law of the state in which the court is sitting.

The court also rejected[43] an *Erie R.R. v. Tompkins*[44] argument urged by the trustee for the application of the Tennessee policy of unenforceability. It would appear that the court properly rejected the argument based upon *Erie* since the United States Supreme Court has indicated that federal law will control the allowance of claims in bankruptcy and reorganization cases.[45] Accordingly, the trustee should have presented

39. 103 Tenn. 262, 52 S.W. 879 (1899). Although the court's approach can be criticized for making the case turn on the vagaries of judicial usage of the terms "void" and "voidable," *cf.* Thompson v. England, 226 F.2d 488 (9th Cir. 1955), without inquiring as to the Tennessee policies underlying the qualification requirement and the sanctions of unenforceability of contracts sometimes applied against unqualified foreign corporations, the court was compelled to determine whether an obligation existed or not under local law of which cognizance would be taken in reorganization proceedings. Accordingly, the court may have felt that an inquiry in more depth than whether the claim asserted was characterized as void or voidable by local law might involve the federal court in an apparent conflict with the Bankruptcy Act's incorporation of state substantive law. *E.g.*, Bankruptcy Act §§ 70(a),(c), 52 Stat. 879-81 (1938), as amended, 11 U.S.C. § 110 (1958).

40. 332 F.2d at 650.

41. Bankruptcy Act § 70(c), 30 Stat. 565 (1898), as amended, 11 U.S.C. § 110(c) (1958): "The trustee may have the benefit of all defenses available to the bankrupt as against third persons, including statutes of frauds, usury, and other personal defenses; and a waiver of such defense by the bankrupt after bankruptcy shall not bind the trustee. . . ."

A prior case involving the same issues as the instant case also failed to discuss the relevance of § 70(c). Kelly, Clover & Vale, Inc. v. Kramer, 198 F.2d 392 (7th Cir. 1952), *cert. denied*, 344 U.S. 914 (1953).

42. *Cf.* Restatement, Contracts § 13, *illustration* (1932), which contemplates in the circumstances of the example a tendering back of benefits received as a prerequisite to the avoidance of the voidable contract there involved.

43. 332 F.2d at 650.

44. 304 U.S. 64 (1938).

45. Vanston Bondholders Protective Comm. v. Green, 329 U.S. 156, 162 (1946)

the issue not whether apart from section 70(c), state or federal law shall control the allowance of claims, but rather whether state policies ought to be relevant in the application of federal law.[46] In the circumstances of the instant case and apart from the section 70(c) argument, it is the author's opinion that unless the federal court could provide a means of promoting compliance with state qualification requirements, such as allowance of the claim conditioned upon qualification, the federal court correctly refused to apply state policies.

If the unenforceability in Tennessee courts of an obligation acquired by an unqualified foreign corporation in the course of doing business in Tennessee would not be removed by subsequent qualification,[47] then the Tennessee courts, in imposing such a heavy penalty for nonqualification, would follow a small minority of states.[48] Were the federal court to follow such a policy and disallow the claim in reorganization proceedings, it would be applying a punishment out of proportion to the wrong[49] and not because of a policy of the forum but because of a policy of another political entity.[50] It would seem that only the strongest of policy reasons of the forum[51] should bar a creditor from recovering upon his claim for all time.[52]

(considering "whether allowance of [a] . . . claim would be compatible with the policy of the Bankruptcy Act."): "In determining what claims are allowable and how a debtor's assets shall be distributed, a bankruptcy court does not apply the law of the state where it sits."

46. See text accompanying notes 41-42 *supra.*

47. Cary-Lombard Lumber Co. v. Thomas, 92 Tenn. 587, 22 S.W. 743 (1893); *cf.* Bush Bldg. Co. v. Mayor & Aldermen of Manchester, 189 Tenn. 203, 255 S.W.2d 31 (1949) (plaintiff corporation's suit on contract dismissed because of failure to pay license fee to do business in Manchester until after work subject of contract completed). See Note, 63 COLUM. L. REV. 117, 128 n.73 (1963). *But see* Caesar v. Capell, 83 Fed. 403, 424 (W.D. Tenn. 1897). It is hoped that the Tennessee courts will revise the scope of the policy of unenforceability to permit subsequent qualification to render previously contracted obligations enforceable. The contrary rule would not only place an inordinately high penalty upon what appears to be only a slight defanlt, but it would require foreign corporations to construe correctly a vague and nncertain mass of deeisions at the peril of loss of their property.

48. See Note, *supra* note 47, at 128.

49. Compare Woods v. Interstate Realty Co., 337 U.S. 535, 540 (1949) (Jackson, J., dissenting): "the amount of this punishment bears no relation to the amount of the wrong done the State in failing to qualify and pay its taxes. The penalty thus suffered does not go to the State, which sustained the injury, but results in unjust enrichment of the debtor, who has suffered no injury from the creditor's default in qualification." *Accord,* Dunlop v. Mercer, 156 Fed. 545, 557-58 (8th Cir. 1907).

50. Although federal courts apply the state policy of unenforceability of contracts of unqualified foreign corporations in diversity cases, Woods v. Interstate Realty Corp., *supra* note 49, the application of that policy is grounded upon a federal policy of discouraging forum shopping by eliminating differences in outcome when identical issues are litigated in the federal and state courts. See *id.* at 538. "The contrary result would create discrimination against citizens of the State in favor of those authorized to invoke the diversity jnrisdiction of the federal courts." Only to the extent that a choice existed between a federal and state court reorganization proceedings would the *Erie* rationale apply.

51. Prior to the *Erie* case, the federal courts recognized the claims of unqualified foreign corporations although such claims were unenforceable in the courts of the

Both traditionally and on an analysis of property, the federal court would be justified in refusing effect to the Tennessee unenforceability policy on the ground of its punitive effect.[53]

On the alternative assumption that Tennessee policy would bar a foreign corporation from suing in a Tennessee court on an obligation only during the period of non-qualification,[54] a refusal to permit the nnqualified foreign corporation to share in reorganization proceedings would over-enforce Tennessee policy by changing a temporary unenforceability into a per-

state in which the federal court was sitting. David Lupton's Sons Co. v. Automobile Club, 225 U.S. 489 (1912), *overruled as to diversity cases*, Woods v. Interstate Realty Corp., *supra* note 49. The cases in which such claims were recognized included bankruptcy proceedings. Cobb v. McDonald-Weist Logging Co., 278 Fed. 165 (9th Cir. 1921); Dunlop v. Mercer, 156 Fed. 545 (8th Cir. 1907). See 2 Remington, Bankruptcy § 1001.75 (1956); 3 Collier, Bankruptcy ¶ 63.07[6] (14th ed. 1964). *But see In re* Montello Brick Works, 174 Fed. 498 (E.D. Pa. 1909). *But cf. In re* Meyer & Judd, 1 F.2d 513, 525-26 (W.D. Tenn. 1924). A federal court has recognized and allowed such a claim in reorganization proceedings subsequent to the *Erie* case and the *Woods* case. *In re* V-I-D, Inc., 198 F.2d 392 (7th Cir. 1952), *cert. denied*, 344 U.S. 914 (1953). Since the *Erie* decision was limited to federal court actions whose jurisdiction was based upon diversity of citizenship, and the overruling of *David Lupton's Sons Co. v. Automobile Club* was expressly limited to diversity cases, it would seem that the federal policy of recognizing the claims of unqualified foreign corporations may continue in nondiversity cases. Although some of the pre-*Erie* cases may be rationalized on the ground that little consideration was given in them to the desirability of federal court deference to state policies in appropriate circumstances, the arguments in favor of deference to state policies seem inappropriate when applied to state policies of a purely punitive character.

52. A provable claim which is not allowed in the reorganization proceedings will be permanently barred. Bankruptcy Act § 226, 52 Stat. 898 (1938), as amended, 11 U.S.C. § 626 (1958). *Cf.* Bankruptcy Act § 17, 30 Stat. 550 (1898), as amended, 11 U.S.C. § 35 (1958). If the creditor could successfully urge in a later proceeding that his claim had not been provable or that it had not been based upon an existing "debt" on a theory which would equate unenforceability of the debt with its nonexistence, a failure of the claim to be allowed in the instant reorganization proceedings would not necessarily involve a permanent bar to the claim if the Tennessee policy of unenforceability were a temporary rather than a permanent one. See note 47 *supra*. See Bankruptcy Act § 228, 52 Stat. 899 (1938), as amended, 11 U.S.C. § 628 (1958). *Cf.* Bankruptcy Act § 17, 30 Stat. 550 (1898), as amended, 11 U.S.C. § 35 (1958). Consider whether a Tennessee policy of temporary unenforceability would support an argument that the claim was "contingent" and not provable. Bankruptcy Act §§ 57(d), 63(a), 30 Stat. 560, 563 (1898), as amended, 11 U.S.C. §§ 93, 104 (1958).

53. See note 49 *supra*. It would seem to the author that generally a decision of a forum to apply a policy of another jurisdiction ought principally to be governed by a criterion of fairness to the parties. Such criterion would largely avoid the imposition of a punitive policy of another jurisdiction upon one of the parties solely because of deference to such other jurisdiction. Something of this notion may underlie the traditional concept that the "penal" laws of one jurisdiction will not be enforced by another jurisdiction. *Cf.* The Antelope, 23 U.S. 66, 123 (1825); See notes 49 & 51 *supra*.

54. This is the policy of most states which have statutes governing the question of an unqualified foreign corporation to sue in their courts. See Note, *supra* note 47, at 125.

manent unenforceability.[55] The reasons set forth in the preceding paragraph for not enforcing Tennessee policy in a reorganization would apply a fortiori to preclude over-enforcement of that policy.

A possible recognition of Tennessee interests which would avoid the purely punitive effect of a disallowance in the reorganization proceedings would be reached if the reorganization court were to allow the claim of the foreign corporation on condition that it qualify or undertake to qualify. Another reconciliation of the interests of Tennessee with the interests of the foreign corporation would be to permit the foreign corporation to share in the reorganization, but withhold the distribution of the share of the foreign corporation until the Tennessee taxing authorities are paid, and possibly until an agent for service of process is appointed.[56]

Finally, the federal statute[57] administered by the court itself lays down a "fair and equitable"[58] standard to govern reorganization proceedings. In the present situation, only the non-punitive facet of state policy, *i.e.*, the allowance of the claim conditioned upon qualification or other assurance of satisfaction of the qualification duties, would avoid conflict with the duty of the federal court to distribute the interests in the reorganized corporation among its creditors and security holders on the basis of fairness and equity.

In *Smartt v. Coca-Cola Bottling Corp.*,[59] the United States Court of Appeals for the Sixth Circuit affirmed the dismissal by the United States Court for the Eastern District of Tennessee of a declaratory judgment and injunction suit directed against the recapitalization of a Delaware corporation which would change outstanding class A stock into debentures. The plaintiffs based their claim for relief upon allegedly misleading statements in notices of a proposed stockholders' meeting sent to the class A stockholders, and also upon the misleading effect that a failure to pay dividends upon the class A stock allegedly had upon the holders of such stock.

The corporation defended upon the ground that it was not subject to the jurisdiction of the Tennessee courts. The Sixth Circuit had earlier affirmed the dismissal of the action in 1963.[60] At that time service had been made upon a Chattanooga broker who had advised with respect to the recapitali-

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55. The permanent unenforceability results from the finality of the reorganization proceedings. See note 52 *supra*.

56. The qualification requirement is designed to insure that a current copy of the corporate charter of the foreign corporation is on file with the Secretary of State, TENN. CODE ANN. §§ 48-902, -905, -910, 48-911 (Supp. 1964), and to insure the collection of taxes and fees. *Cf.* TENN. CODE ANN. §§ 48-917, -922 (Supp. 1964). Since the Tennessee statutes, however, provide a method for subjecting an unqualified foreign corporation to the jurisdiction of the Tennessee courts, TENN. CODE ANN. § 48-923 (Supp. 1964), it would seem that the only real interest that Tennessee has in requiring qualification (apart from insuring that a current copy of its charter is on file with the Secretary of State) lies in the collection of taxes.

57. Bankruptcy Act, ch. 10, 52 Stat. 883 (1938), as amended, 11 U.S.C. §§ 501-676 (1958).

58. Bankruptcy Act § 221(2), 52 Stat. 890 (1898), as amended, 11 U.S.C. § 621(2) (1958).

59. 337 F.2d 950 (6th Cir. 1964).

60. 318 F.2d 447 (6th Cir. 1963).

zation and aided in soliciting approval of the change during stockholders' meetings in Chattanooga; when service upon such broker was set aside,[61] service was made upon the Tennessee Secretary of State and upon one of the defendant's directors who resided in Tennessee.[62] In the 1963 opinion, the court held that even though the stockholders' meeting at which the allegedly wrongful recapitalization took place occurred in Chattanooga, the corporation was not subject to the jurisdiction of the Tennessee courts because it was not "doing business" in Tennessee.[63] The "doing business" definition embodied in section 20-220[64] was adverted to by the court,[65] but was not satisfactorily handled by it. That part of the definition which refers to a foreign corporation "having any transaction with persons, or having any transaction concerning property situated in this state,"[66] the court improperly paraphrased when it stated that jurisdiction would exist "if the foreign corporation appears to have committed or threatened some serious damage to person or property."[67] The court thus changed the phrase "transactions with persons . . . situated in this state" into a phrase relating to the commission or the threat of damage to the person. The judicial paraphrase appears to have a different connotation from the statutory original.

Although the court stated that "the alleged tortious conduct on the part of the defendant corporation does not, in and of itself afford a basis of jurisdiction under the Tennessee law,"[68] it would be hard to see why tortious conduct[69] in connection with "a transaction involving persons . . .

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61. The district court found that "the broker was not a proper person upon whom service could be had in order to acquire jurisdiction of the defendant corporation." 318 F.2d at 448. In setting aside service on the broker, the court seems to have ruled that service was upon a person not authorized to receive it. See TENN. CODE ANN. § 20-221 (1956). Compare TENN. CODE ANN. §§ 20-217, -218 (1955).

62. Although service on the director may have constituted an attempt to act under §§ 20-221, -217, or -218, the attempt to serve the corporation by service on the Secretary of State would seem to have constituted an attempt to act under TENN. CODE ANN. § 48-923 (Supp. 1964).

63. 318 F.2d at 449.

64. Section 20-220 of the Tennessee Code provides as follows:

"Foreign corporations subject to actions.—Any corporation claiming existence under the laws of the United States or any other state, or of any country foreign to the United States, or any business trust found doing business in this state, shall be subject to suit here to the same extent that corporations of this state are by the laws thereof liable to be sued, so far as relates to any transaction had, in whole or in part, within this state, or any cause of action arising here, but not otherwise. Any such corporation or trust having any transaction with persons, or having any transaction concerning any property situated in this state, through any agency whatever, acting for it within the state, shall be held to be doing business here within the meaning of this section."

The last sentence of § 20-220 contains the definition of "doing business" applicable to that section.

65. 318 F.2d at 448-49.

66. See note 64 *supra*.

67. 318 F.2d at 449.

68. *Id.* at 449-50.

69. It might be noted that TENN. CODE ANN. § 48-1644(b) (1955), appears to make unlawful in connection with a recapitalization "any device, scheme or artifice to defraud"

situated in this state"[70] which is the basis of the plantiff's claim for relief would not satisfy the literal language of section 20-220, except for a judicial gloss on that section which may have imposed upon it a judicially evolved "doing business" requirement in addition to the statutory "doing business" requirement contained in that section.[71]

Although the court did not discuss the relationship between the statutory and the judicial "doing business" requirement[72] with great clarity, it did consider the most recent Tennessee jurisdictional cases.[73] The court, in its 1963 opinion, concluded that although the Tennessee courts had been "in step with the trend toward expanding the permissible scope of state jurisdiction over foreigu corporations,"[74] Tennessee had not yet broadened the scope of its jurisdictional assertion to the full extent permissible under the federal Constitution and under the prevailing construction of the Tennessee jurisdictional statutes, the defendant would not be subject to Tennessee jurisdiction.

In the instant case, intervening plaintiffs sought the retention of the case in the United States Court for the Eastern District of Tennessee on the basis of section 48-923[75] of the Tennessee Code Annotated which provides for substituted service on the Secretary of State for corporations "doing business" within Tennessee which have not qualified to do business here. In dismissing the intervenors' contention summarily, the court stated that the jurisdictional issue had already been dealt with in the prior opinion.[76] In so holding, the court evidenced the understanding that in the circumstances of this case the "doing business" concept under section 48-923 requires at least the same amount of activity as the "doing business" concept which is applicable to section 20-220.[77]

and "any act, practice, transaction or course of business which operates or would operate as a fraud or deceit upon the purchaser or seller." Although § 48-1644(b) is limited in its application to any offer to sell or to buy securities or any sale or purchase of securities, those of such terms which relate to the sale side of transactions are broadly defined. TENN. CODE ANN. § 48-1602(f) & (h). Recapitalizations which are exempted from most of the provisions of the Tennessee Securities Law, TENN. CODE ANN. § 48-1632(B), are not exempted from § 48-1644(B).

70. TENN. CODE ANN. § 20-220 (1955). See note 64 *supra*.

71. See Gifford, *Corporations—1962 Tennessee Survey*, 16 VAND. L. REV. 685, 693 n.44 (1963).

72. The Tennessee courts seem to have read into the Tennessee statutes governing jurisdiction over foreign corporations a "doing business" requirement which is somewhat more strict than that which would be imposed by the federal constitution. *Id.* at 685-95.

73. The court considered Shuler v. Wood, 198 F. Supp. 801 (E.D. Tenn. 1961); Atchison, T. & S. F. Ry. v. Oritz, 361 S.W.2d 113 (Teun. App. W.S. 1962); Fisher v. Trion, Inc., 49 Tenn. App. 182, 353 S.W.2d 406 (E.C. 1961); Tucker v. International Salt Co., 209 Tenn. 95, 349 S.W.2d 541 (1961). The court also relied upon Denson v. Webb, 23 Tenn. App. 599, 136 S.W.2d 59 (W.S. 1938).

74. 318 F.2d at 449. The court perhaps over liberally described the content of the Tennessee "doing business" requirement heretofore existing by stating that "this test appears satisfied when the minimal contacts making it fair and reasonable to exercise judicial power are established."

75. TENN. CODE ANN. § 48-923 (Supp. 1964).

76. 337 F.2d at 951.

77. Compare text accompanying uote 72 *supra*. It would seem that § 20-220 ought to

The instant case is another example[78] of a dispute concerning the reach of Tennessee law in relation to foreign corporations having transactions with Tennessee residents or having other contacts with Tennessee.[79] Most of the statutes antedating the 1965 session of the legislature which regulate jurisdiction over foreign corporations were enacted long prior to the *International Shoe Co. v. Washington*,[80] opinion in which the United States Supreme Court broadened the scope of state power over foreign corporations. The Tennessee courts accordingly have had little direction from the legislature with respect to the criteria they should employ in deciding whether to exercise jurisdiction over foreign corporations in situations in which the governing legislation may have been phrased in restrictive terms only because of pre-*International Shoe* constitutional limitations on state power or in which the governing legislation, as in the case of section 20-220, is broadly phrased, but perhaps due to such pre-*International Shoe* constitutional conceptions, the Tennessee courts may have construed the statute more narrowly than their language would justify. The Tennessee courts, as pointed out in the 1963 *Smartt* opinion,[81] have been in the process of broadening the scope of their jurisdiction, but they may have felt reluctant to increase the scope of their jurisdiction to the full extent permissible under the new prevailing *International Shoe* test without legislative approval.

Chapter 67 of the Public Acts of 1965[82] is a legislative attempt to solve

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have a greater reach than § 48-923 since § 20-220 applies only to causes of action having a nexus with Tennessee. *Compare* McGee v. International Life Ins. Co., 355 U.S. 220 (1957), *with* Hanson v. Denckla, 357 U.S. 235 (1958). To the extent that the judicially originated "doing business" requirement is read into both sections, however, § 20-220 may be prevented from having that greater reach. It might be noted that some judicial limitation on the literal language of § 20-220 may be required, however, since the language of that section relating to a cause of action arising in Tennessee might in some circumstances extend the jurisdiction of the Tennessee courts beyond that permissible under the prevailing liberal federal constitutional standards. Although the court in its instant opinion, however, referred to Tenn. Code Ann. § 48-923 as "newly cited," 337 F.2d at 951, § 48-923 may have been involved in service on the Secretary of State referred to in the court's earlier opinion.

78. See the authorities cited in note 14 *supra*; Morgan & Handler, *Procedure & Evidence—1961 Tennessee Survey (II)*, 15 Vand. L. Rev. 921, 933-35 (1962); Gifford, *supra* note 71, at 685-95.

79. Tenn. Code Ann. 48-923 (repl. vol. 1964), which was adopted by the legislature as § 1 of chapter 237 of the Public Acts of 1955 is an exception, but § 48-923 seems to incorporate by reference the "engage in business" provisions of the qualification statutes, enacted in 1929. Tenn. Code Ann. § 48-901 (Supp. 1964). Tenn. Pub. Acts 1929, ch. 13, § 31.

80. 326 U.S. 310 (1945).

81. See note 74 *supra*, and accompanying text.

82. Tenn. Pub. Acts 1965, ch. 67, §§ 1-7, provides as follows:

Section 1. *Be it enacted by the General Assembly of the State of Tennessee*, That persons who are non-residents of Tennessee and residents of Tennessee who are outside the State and cannot be personally served with process within the State are subject to the jurisdiction of the Courts of this State as to any action or claim for relief arising from:

(a) The transaction of any business within the State;

(b) Any tortious act or omission within this State;

the jurisdictional problems with which the courts have been struggling since the *International Shoe* decision. It embodies the "long arm" approach

(c) The ownership or possession of any interest in property located within this State;
(d) Entering into any contract of insurance, indemnity, or guaranty covering any person, property, or risk located within this State at the time of contracting;
(e) Entering into a contract for services to be rendered or for materials to be furnished in this State.

"Person" as used herein shall include corporations and all other entities which would be subject to service or process if present in this State. Any such person shall be deemed to have submitted to the jurisdiction of this State who acts in the manner above described through an agent or personal representative.

SECTION 2. *Be it further enacted,* That service of such process shall be made by lodging (by plaintiff or his attorney) the original summons and a copy certified by the clerk of the court in which action is brought, with a fee of Two Dollars ($2.00), with the Secretary of State, who shall promptly send, postage prepaid, the certified copy by registered return receipt mail to the defendant, along with a written notice that service was so made. In case it shall appear, either before or after the lodging of process as above provided that such non-resident is dead, then either original or alias process may issue hereunder directed to the personal representative of such non-resident deceased and shall be sent as herein provided to the probate court of the county and state of the residence of the deceased at the time of his death. No appearance need be made nor shall judgment be taken against such personal representative until the lapse of sixty (60) days from the date of mailing the process herein to such probate court. The procedure for mailing such process and proof of service thereof shall be as provided in this section in the next succeeding section hereof for the service upon living persons. The fee of Two Dollars ($2.00) so paid by plaintiff, when fact of payment is endorsed on the original process by the Secretary of State, shall be taxed as plaintiff's cost, to abide the judgment.

In case delivery of said process so made by registered mail be refused by the addressee thereof, such refusal to be evidenced by appropriate notation of such fact by the postal authorities, such refusal shall be deemed the equivalent of delivery and adequately constitutes service.

SECTION 3. *Be it further enacted,* That the original process, endorsed as below, an affidavit of the Secretary of State setting forth his compliance with the requirements of the preceding section, and the return-receipt signed by, or duly in behalf of, the defendant, shall be attached together and sent to and filed by said clerk. There shall be endorsed on the original process by the Secretary of State over his signature the date of his mailing the certified copy to the defendant and the date on which he received the return-receipt of the defendant; thereupon service on the defendant shall be consummate. An act of a deputy or regular assistant of the Secretary of State in his behalf, hereunder, shall be deemed the equivalent of the act of the latter.

SECTION 4. *Be it further enacted,* That in addition to service of process on the Secretary of State as hereinbefore set forth, personal service of process may be made upon any party outside the state by any person over twenty-one years of age and not a party to the action. No order of court shall be required to constitute such person a proper officer to receive and execute the process. An affidavit of the person serving the process shall be filed with the Clerk of the court in which the action is pending, stating the time, manner and place of service.

SECTION 5. *Be it further enacted,* That only causes of action arising hereafter or heretofore from past or future transactions as set forth in Section 1 hereof may be asserted against the defendant in an action in which jurisdiction over him is based upon this law.

SECTION 6. *Be it further enacted,* That nothing herein contained shall limit or affect the service of process in any other manner now provided by law. This law is in the nature of remedial legislation and it is the legislative intent that it be given a liberal construction.

to jurisdiction illustrated by the *McGee v. International Life Ins. Co.* case, and will perform the functions which section 20-220 has heretofore failed to perform.

In *Louisville & Nashville R.R. v. Hooper*,[83] the Court of Appeals for the Middle Section of Tennessee reversed a tort judgment rendered by the Circuit Court of Davidson County against a defendant foreign corporation on the ground of improper venue. The basis for the decision was section 20-401[84] which provides that in the case of a transitory action in which both the plaintiff and the defendant "reside" in the same county, the action must be tried in such county. In so holding, the court relied upon and followed[85] *McClearen v. United States Fidelity & Guaranty Co.*,[86] in which suit was required to be tried in the county in which the cause of action arose[87] in which the plaintiff resided and in which the defendant foreign corporation maintained an agent upon whom service could be made.

Some confusion seems to have existed about the application of section 20-401 to corporations. This confusion seems to have resulted from the fact that the mandatory venue requirement of section 20-401 depends upon where the parties "reside." Since prior decisions have held that a domestic corporation does not "reside" in any county other than the county in which its principal office is located,[88] section 20-401 applies to a domestic corporation only if the opposing party resides in the county in which the corporation's principal office is located. Accordingly, a domestic corporation, in any case in which the plaintiff resides in any county other than the one in which such corporation's principal office is located, may be sued in any county in which it maintains an office or agent.[89] Since a foreign corporation has been held to have no "principal" office in the state[90]—and since the courts have equated "principal" office with residence in the case of domestic corporations[91]—it would appear under the reasoning applied to domestic corporations, that section 20-401 would have no application to foreign corporations and that such corporations could be sued in any county in which they maintained an office or agent. Such has not been the case, however.

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83. 375 S.W.2d 868 (Tenn. 1963).

84. TENN. CODE ANN. 20-401 (1955), Transitory actions.—"In all transitory actions, the right of action follows the person of the defendant, unless otherwise expressly provided. If the plaintiff and defendant both reside in the same county, such action shall be brought in the county of their residence."

85. 375 S.W.2d at 872.

86. 168 Tenn. 268, 77 S.W.2d 451 (1935).

87. Although § 20-401 does not mention the factor of the location of the accrual of the cause of action, the court seemed to consider that factor important. See note 88 *infra*.

88. Skaggs v Tenn. Cent. Ry., 193 Tenn. 384, 246 S.W.2d 55 (1952); *cf.* Toppins v. East Tenn., V. & G.R.R., 73 Tenn. 600 (1830). The *Skaggs* opinion may have contained a hint that a domestic corporation has no residence for § 20-401 purposes in the language which stated that the defendant domestic corporation *"if it has a residence,* is a resident of Davidson County." 246 S.W.2d at 56. (Emphasis added.)

89. Skaggs v. Tennessee Cent. Ry., *supra* note 88.

90. *Ibid.*

91. See text accompanying note 88 *supra.*

In the *McClearen* case, a foreign corporation successfully urged the application of the predecessor of section 20-401 to require trial in the county in which the cause of action arose,[92] in which the plaintiff and an individual defendant resided, and in which the defendant foreign corporation maintained an agent upon whom service could be made.[93] Subsequently in *Tims v. Carter*,[94] the court announced the position that "where the plaintiff and a material defendant or defendants reside in the same county, this county being the county where the cause of action accrued, that then the county of the residence of these parties should be the county of action for venue purposes."[95] Since *McClearen* could be construed to fall within the broad principal announced in *Tims*, *i.e.*, that section 20-401 would apply to a defendant not a resident of the county where the plaintiff resided and the cause of action accrued if another "material defendant" was such a resident,[96] it was not clear at the time of the institution of the present suit that a foreign corporation would be held to "reside" for purposes of section 20-401 in any county in which it maintained an officer or agent.

The instant case would seem to clarify the effect of section 20-401 upon venue over foreign corporations since it applied that section to litigation involving a single defendant foreign corporation. Henceforth, the bar probably will understand that a foreign corporation "resides" for purposes of section 20-401 in every county in which it has an agent for service of

92. Although a number of decisions have applied § 20-401 on a rationale which includes conveniences of witnesses, *e.g.*, Tims v. Carter, 192 Tenn. 386, 241 S.W.2d 501 (1951); McClearen v. United States Fid. & Guar. Co., 168 Tenn. 268, 77 S.W.2d 451 (1935); Haynes v. Woods, 151 Tenn. 163, 268 S.W. 632 (1925); *cf.* Denny v. Webb, 199 Tenn. 39, 281 S.W.2d 698 (1955), § 20-401 does not mention witnesses or the place where the cause of action arose. The most convenient place for trial would often be the place where the cause of action arose if the witnesses lived there, *cf.* Thomas v. Altshelter, 235 S.W.2d 806, 808 (Tenn. 1951), regardless of the residences of the plaintiff and defendant.

93. The opinion is not clear as to whether the court is holding that § 20-401 applies because the maintenance of an agent in the county of the plaintiff's residence is equivalent to residence by the defendant foreign corporation for purposes of § 20-401 venue, or whether § 20-401 applies because an individual co-defendant resided in the county of the plaintiff's residence. The opinion contains some suggestion that the trial judge may have thought that the defendant foreign corporation resided in the county of residence of the plaintiff and co-defendant. The supreme court then stated: "Every circumstance required to fix the locality of trial in Lewis County is shown by the facts stated in the plea. Sections 8641 and 8751 of the Code require that an action shall be abated, if challenged by plea in abatement, when the plaintiff and the defendant both reside, at the time when the suit is brought, in the same county. Those sections and § 8643 of the Code, authorizing service upon local corporate agents, very definitely fix the venue in Lewis County. As said in Haynes v. Wood, *supra* note 92: "sections 8640, 8641 and 8751 of the Code evince the legislative purpose to localize such transitory actions to the county where the action arose and where plaintiff and defendant both reside. The object of that provision being for the convenience of both litigants and witnesses." 375 S.W.2d at 872.

94. 192 Tenn. 386, 241 S.W.2d 501 (1951).

95. *Id.* at 388, 241 S.W.2d at 503.

96. This seems to be the basis on which both the *McClearen* and *Tims* opinions were distinguished in *Skaggs*. 246 S.W.2d at 56.

process while a domestic corporation does not so reside.[97]

In *Gallagher v. Butler*,[98] the Tennessee Supreme Court considered the taxability of distributions in liquidation[99] and distributions in redemption of a shareholder's interest[100] in a corporation. Apparently,[101] because the transactions dealt with by the court had occurred prior to the 1963 amendments[102] to section 67-2609 of the Tennessee Code Annotated, the court construed that section in its unamended form.[103] The court held that distributions in liquidation and redemption were not taxable because the general provision imposing taxes in chapter 26 of title 67 in section 67-2602 which provides that a tax "shall be levied and collected on incomes derived by way of dividends from stocks. . . ." The court held that the language of section 67-2602[104] limiting the tax to incomes derived by way of "dividends" in effect modified the broader language of section 67-2609 relating to the taxation of "earned surplus" when and in whatever manner distributed."[105]

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97. It appears that a foreign corporation not maintaining an office in the state nor an agent to receive service of process other than a designated state official will be deemed to have an agent for service of process in every county of the state, and, accordingly, will be suable in any such county under TENN. CODE ANN. § 20-405 (1955). Cartmell v. Mechanics' Ins. Co., 167 Tenn. 498, 71 S.W.2d 688 (1934). Logically, such a view combined with the approach to residence of a foreign corporation taken in the instant case would limit the county in which such foreign corporation was suable to the county of the plaintiff's residence, at least if such corporation were the only defendant. This appears to be the approach of the Tennessee courts with respect to nonresidents sued under the nonresident motor vehicle law. TENN. CODE ANN. § 20-224 (1955). In such actions, a nonresident is deemed for venue purposes to be a resideut of the plaintiff's county of residence. See Carter v. Schackne, 173 Tenn. 44, 114 S.W.2d 787 (1938). It is not clear, however, that service on a statutory agent will cause a foreign corporation to be deemed a resident of the plaintiff's county of residence in all cases. See, *e.g.*, Brown v. Stone & Webster Eng'r Co., 181 Tenn. 293, 181 S.W.2d 148 (1944) (workmen's compensation case). Note also the dictum in the McClearen case, 168 Tenn. at 271, 77 S.W.2d at 452.

98. 378 S.W.2d 161 (Tenn. 1964).

99. *Coolidge v. MacFarland; French v. King; Chapin v. Butler,* and *First Am. Nat'l Bank v. Butler* were consolidated with the principal case.

100. Gallagher v. Butler, *supra* note 98; First Am. Nat'l Bank v. Butler, *supra* note.

101. The opinion does not provide information with respect to the dates of all of the allegedly taxable events.

102. TENN. CODE ANN. § 67-2609 (Supp. 1964).

103. 378 S.W.2d at 164.

104. Section 67-2602 provides as follows:

"Income taxable—General rate.—For each calendar year, to be computed from January 1st to January 1st of each year, an income tax in the amount of six per cent (6%) per annum (except as provided in § 67-2603), shall be levied and collected on incomes derived by way of dividends from stocks or by way of interest on bonds of each person, partnership, association, trust and corporation in the State of Tennessee who received, or to whom accrued, or to whom was credited during any year income from the sources above enumerated except as hereafter provided."

105. The court also relied in part upon prior administrative construction of the statute. 378 S.W.2d at 166. Reference to prior administrative construction is often useful to a court in preventing an administrative body from discriminating against a person by treating him differently from others. In such a case the court can require the administrative body to accord equal treatment by requiring it to follow the same construction of the statute it is administering in the case before it as in

Since the significance of the instant decision can be appreciated best by a reference to the statutory provisions dealt with by the court, it may be appropriate to set out here section 67-2609 in its original form. As originally worded, section 67-2609 provided that:

> No distribution of capital by stock dividend, or liquidation or otherwise, shall be taxed as income; but earned surplus shall not be considered as capital, and shall be taxed as income when and in whatever manner it may be distributed, irrespective of when it was earned.

It is apparent that an understanding of the application of former section 67-2609 requires an understanding of the meaning of the word "capital" as there used. Specifically, it is necessary to determine whether the terms "stock dividends" and "liquidation" as there used to describe certain distributions have a broader meaning than the phrase "distribution of capital" as there used. Thus, the phraseology of that provision may have been intended to convey the meaning that all stock dividends or all distributions in liquidation were distributions of capital and therefore exempt from tax, or it may have been intended to mean that some distributions by stock dividend or in liquidation were not "capital" distributions and therefore taxable either on the general ground that such distributions constituted "income" or on the more specific ground that such distributions, in some cases, might be deemed distributions of "earned surplus."

Lawrence v. MacFarland,[106] gave a partial answer to the foregoing question by holding that in some circumstances a stock dividend could have a broader meaning than the phrase "distribution of capital." That case held that a "stock dividend" of an investment company with respect to which the shareholders had the option[107] of accepting cash or the stock distribution was a distribution of "earned surplus" and therefore taxable.

The legislature responded to the *Lawrence v. MacFarland* decision by amending[108] section 67-2609 to read as follows:

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former cases. In the instant case, the taxing authorities may not have attempted to treat particular taxpayers in a discriminatorily adverse way, but rather they may have attempted a major shift in policy applicable to all taxpayers. Compare Bates & Guild Co. v. Payne, 194 U.S. 106 (1904). The court may have used prior administrative construction in the instant case, however, because the court felt that a change in tax policy as applied to the instant taxpayer might have embodied a certain amount of frustration of the taxpayers' justified reliance upon such prior administrative construction. If so, the opinion may indicate the desirability for methods of informing the public about prospective changes in tax policy which would avoid the prospect of frustrating justified reliance and would also avoid freezing tax policy into preexisting modes by judicial restatement of administrative practice in terms of statutory construction. *Cf.* Gifford, *Administrative Law Study*, 150 (TENN. LAW REVISION COMM'N 1964).

106. 209 Tenn. 376, 354 S.W.2d 78 (1962), commented upon in Hartman, *State and Local Taxation—1962 Tennessee Survey*, 16 VAND. L. REV. 865, 874-77 (1963).

107. The option in each shareholder to accept cash in lieu of the stock distribution would appear to support the taxability of the transaction. Compare INT. REV. CODE OF 1954, § 305(b)(2). *Cf.* 43 ARB, ch. 7, ¶ 3(d), which excepts from the general conclusion that a stock dividend does not result in income to the recipient, the situation in which "each shareholder is given an election to receive cash or shares."

108. Tenn. Pub. Acts 1963, ch. 273, 83d Gen. Assembly.

> 67-2609. Distributions of capital exempt.—No distribution of capital shall be taxed as income under this chapter, and no distribution of surplus by way of stock dividend shall be taxable in the year such distribution is made; but all other distributions out of earned surplus shall he taxed as income when and in whatever manner made, irrespective of when such surplus was earned. Provided, however, that stock dividends issued within one (1) year of liquidation shall be taxable in the year received to the extent made out of earned surplus; and further provided that gains over and above the par or original pro rata capital value of original shares held shall be taxed to the shareholder upon any transfer of stock to nonresidents in the year of such transfer, when such transfer occurs within one (1) year prior to liquidation or redemption. There shall, however, be exempt from taxation under the provision of this section, distribution made pursuant to decrees ordering divestiture of stock in enforcement of anti-trust statutes.

The amended section retains the exemption from taxation for capital distributions, but enlarges or clarifies the stock distribution exemption from applying only to a distribution of capital by way of stock dividend to include an exemption from tax in the year in which the distribution is made covering all distributions of surplus[109] by way of stock dividend. Such stock dividend exemption would now apparently include distributions "by way of stock dividends" which capitalized earned surplus, and, accordingly, would reverse in that connection the decisional law made by *Lawrence v. MacFarland* despite the fact that in that case the distribution probably represented a capitalization of earned surplus.[110]

It will be noted, however, that the amended section exempts a stock dividend from taxation "in the year such distribution is made." Apart from the narrow language of section 67-2602, an inference, accordingly, would exist that such a distribution might be taxable in some other year. This inference is reinforced by the proviso that all gains over the par value of the stock shall be taxed if transferred by a resident to a nonresident within one year from liquidation. The apparent reason for such a provision would seem to be that the legislature considered that such a transfer would likely be an attempt to avoid the tax otherwise payable by a resident upon liquidation of the corporation. That is to say the assumption underlying the wording of the amended section 67-2609 is that upon liquidation of a corporation the gain over "the par or original pro rata capital value of original shares" in such corporation would be taxed. Such an analysis would also apply to the "redemption" of stock. Since the legislature opposed redemption to liquidation in the second proviso, it appears that redemption probably was thought to mean something other than liquidation. Redemption, accordingly, would seem to include payment in cancellation of stock and would include the case of payments in divestiture of a stockholder interest. Accordingly, under the above analysis,

109. As worded the exemption would include not only stock dividends representing "capital surplus" or "reduction surplus" or other "non-earned" surplus, but would include stock dividends representing earned surplus.

110. TENN. CODE ANN. § 48-211 (1955), provides that the surplus of a corporation issuing a stock dividend shall be reduced in an amount equal to the fair value of the stock issued as a dividend.

taken by itself,[111] the amended section 67-2602 would contain inferences that the liquidation payments and the payments in divestiture of stockholder interests involved in the present case would be taxable. The antitrust decree exemption[112] re-enforces the foregoing conclusions, since the antitrust decree exemption would be largely unnecessary if distributions in eliminations of stockholder interests or in liquidations were nontaxable.

It should be pointed out that the first clause of the proviso appears somewhat inconsistent with an assumption that earned surplus will be taxed upon liquidation or redemption. If such tax will be imposed within one year from a stock distribution, then the legislative purpose in carving out the one year period preceding liquidation from a general exemption from tax is unclear. The legislative purpose would be more clear, however, on the assumption that a stock dividend results in a capitalization of earnings in such a way that upon liquidation or redemption, the distribution of such capitalized earnings would be exempted from taxation as distributions of "capital." Such a reading of the statute would be premised partly on a legislative policy to exempt from taxation earnings reinvested in Tennessee,[113] and upon the judgment that earnings made within one year from liquidation could not be effectively invested in Tennessee and accordingly ought not to be allowed to escape taxation by capitalization through the stock dividend route.

Such an analysis has a superficial attraction. "Capital" is defined in section 48-201[114] "for the purpose of beginning business, and for all other purposes" to mean the "aggregate par value" of all par value shares or the aggregate consideration received as consideration for no-par value shares (less any amounts the directors allocate to surplus) plus such amounts as the directors allocate to capital by resolution. Section 48-211[115] permits the

111. That is, not in pari materia with TENN. CODE ANN. § 67-2602 (1955).

112. The antitrust decree exemption was added by a separate amendment. Tenn. Pub. Acts 1963, ch. 167, § 1.

113. Such a policy appears elsewhere in title 67. *E.g.*, TENN. CODE ANN. § 67-502(2) (1955).

114. TENN. CODE ANN. § 48-201 (1955): "'Capital' defined—Paid in surplus on no par shares.—The capital of every corporation to which chapters 1 to 5, inclusive, of this title are made applicable, for the purpose of beginning business, and for all other purposes, shall be defined as the sum of the aggregate par value of all shares of stock having par value issued by the corporation and/or the aggregate amount of consideration received by the corporation for the issuance of shares without par value, together with such additional amounts, if any, as from time to time by resolution of the board of directors may be transferred to capital; provided, however, that any corporation may, by resolution of its board of directors, allocate to surplus, in lieu of capital, the amount of value of any part of the consideration received for the issuance of shares without par value."

115. It might be noted here that the court attempted to relate § 48-211 to former § 67-2609 by making the following statement:

"Section 67-2609 states in plain language that distribution of capital by stock dividends, liquidation or otherwise, shall not be taxed as income. The understanding of this sentence is plain and presents no problem. As a matter of fact, if it provided otherwise it would be in conflict with T.C.A. § 48-211, which states that dividends may be paid to stockholders from a corporation's net earnings or from the surplus of its assets over its liabilities, including capital but not otherwise. The directors of a issuance of stock dividends if an amount of surplus equal to the fair value of the stock distributed as a dividend is transferred to capital. If the "capital" exemption in section 67-2609 has the same meaning as "capital" has in title 48, it would be possible for a continual process of capitalizing earnings to occur either through the issuance of stock dividends or through director resolution with the result that the section 67-2609 "capital" exemption upon liquidation would grow with the earnings of the corporation and upon such liquidation no tax would be payable from that part of retained earnings which had been capitalized.

Such an analysis, however, neglects the fact that the definition of "capital" in section 48-201 was probably made with reference to facets of corporate financial structure only in mind. Moreover, from a policy standpoint,[115a] postponement of taxation on earnings during the period while they are committed to reinvestment in Tennessee seems more justifiable than a total exemption from tax at the shareholder level, including liquidation and redemption—transactions which are compatible with removal of earnings from use within Tennessee.

The postponement of tax for retained earnings approach, however, may furnish the assumption underlying the first clause of the proviso. It may be that the legislature determined that stock dividends should be exempted from tax in order to encourage reinvestment of earnings necessarily resulting from the capitalization of earned surplus required in conjunction with such a stock dividend, but determined that since meaningful reinvestment could not occur within one year from liquidation, no purpose was served in according such an exemption to stock dividends occurring within the year preceding liquidation.

Although the opinion did not mention the effect of the legislative amendments to section 67-2609 in 1963, the court may have felt that its reliance upon the narrowly worded provisions of section 67-2602 would preclude any argument that the legislative changes in section 67-2609 would make distributions in liquidation or in redemption of stockholder interests taxable. The controlling effect of the by-way-of-dividends phrase of section 67-2602 may not be so apparent, however, when viewed in conjunction with the amendments to section 67-2609. In limiting the scope of former section 67-2609 by reading it in pari materia[116] with section 67-2602, the court stated that the former section "should be read as if the words 'by way of dividends' had been placed by the Legislature after the word

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corporation may issue other common or preferred stock as dividends provided it has a surplus equal in value." 378 S.W.2d at 165.
It is unclear exactly how the court thought § 48-211 related to § 67-2609. It is not clear why § 67-2609 could not provide otherwise than it did without conflicting with § 48-211. Section 48-211 requires capitalization of surplus equal in value to the stock distributed, but nothing in § 48-211 would conflict with either the taxability or the non-taxability of "distributions of capital by stock dividends."

115a. In order to give due regard to reasonable expectations of taxpayers, however, it would be best to embody such a policy determination in the form of a prospective rule.

116. 378 S.W.2d at 164.

'distributed.'"[117] The rephrasing of section 67-2609 so adopted by the court is difficult to transpose to the amended version of section 67-2609, however. If the limiting by-way-of-dividends language is carried over to the new section 67-2609, the inference of ultimate taxability of earned surplus on liquidation or redemption raised by the limitations of the exemption from taxation of stock dividends to the year such distributions are made,[118] and the inference of taxability of liquidation or redemption payments to a Tennessee resident raised by the provisions of the second clause of the proviso[119] are not readily reconcilable with the section 67-2602 language so carried over.

117. *Id.* at 165.
118. See text following note 110 *supra.*
119. See text accompanying notes 110-11 *supra.*