Mercer Law Review

Volume 27
Number 1 *Annual Survey of Georgia Law*

Article 3

12-1975

Business Associations

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BUSINESS ASSOCIATIONS

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This survey article deals with recent Georgia cases and statutes in the areas of partnerships, corporations, securities regulation, and fair business practices.

I. PARTNERSHIPS

The only significant case involving partnerships decided during the current survey period was *Mills v. Kochis*, [1] which involved the validity of a repurchase commitment by the general partners to the limited partners in the event of foreclosure proceedings. The commitment, which was contained in the articles of partnership, amounted to an indemnification agreement.

When the partnership failed, the limited partners brought an action against the general partners that was based on the repurchase commitment. Various defenses were raised, the principal one being based on a Georgia statute which states:

> A limited partner shall not receive from a general partner or out of the partnership property any part of his contribution until (a) All liabilities of the partnership except liabilities to general partners and to limited partners on account of their contributions, have been paid or there remains property of the partnership sufficient to pay them.[2]

Taking note of this statute, the court of appeals concluded that the trial court had been in error when it granted the motion of the limited partners for summary judgment. In the words of the court:

> This qualifying language is not in the articles of partnership under consideration, but it is in the law, and is therefore controlling. . . . An agreement to indemnify limited partners made by general partners is enforceable. But it is a condition precedent thereto that creditors other than the partners shall first be paid. . . . [C]reditors take precedence over limited partners . . . regardless of whether or not such a restriction also appears within the articles of partnership themselves.[3]

Mills was a case of first impression in Georgia,[4] and its potential impact

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1. 132 Ga. App. 492, 208 S.E.2d 352 (1974).
2. GA. CODE ANN. §75-417(1) (Rev. 1973).
3. 132 Ga. App. at 494, 208 S.E.2d at 353. The only permissible deviation from this pattern arises when a "limited partner may be considered as an ordinary business creditor in other than partnership contribution situations." *Id.*
4. It should be noted that a New York statute identical to the Georgia provision was previously considered in Herrick v. Guild, 257 App. Div. 341, 13 N.Y.S.2d 115 (1939), with

is considerable. Its result can in no way be considered surprising, however, for the statute upon which it is based is quite clear.

II. CORPORATIONS

A. *Corporation By Estoppel*

The doctrine of corporation by estoppel is based on the concept that

> a person who has contracted or otherwise dealt with a body purporting to be a corporation, is, by reason of having dealt with it as such, estopped from denying its corporate existence.[5]

The validity of the doctrine was reaffirmed by the Georgia Supreme Court during the preceding survey period in the case of *Cahoon v. Ward.*[6]

The doctrine of corporation by estoppel was examined once again in *Walker v. Joanna M. Knox & Associates, Inc.*[7] In that case the court of appeals concluded that "[t]he existence of a corporation cannot be attacked by persons who have dealt with it as a corporation."[8] Ironically, though, the outcome of the case did not really hinge on the doctrine of corporation by estoppel. The trial court had awarded $10,000 to the plaintiff corporation on a theory of quantum meruit, and this result was affirmed by the court of appeals. The trial court had also held, however, that a contract under consideration in *Walker* was invalid because the corporation in question *was nonexistent* at the time of the execution of the contract. This deprived the corporation of certain sums it had sought in reliance on the contract. The corporation, apparently satisfied with its $10,000 quantum meruit award, did not challenge the trial court on this point. Nevertheless, it is certainly regrettable that the position of the trial court regarding the contract was allowed to pass without adverse comment on the part of the court of appeals, for that position is totally contrary to the overall thrust of the doctrine of corporation by estoppel. The treatment of the *Walker* case by the court of appeals is both confusing and inconsistent.

B. *Cumulative Voting*

In *Givens v. Spencer,*[9] the Georgia Supreme Court dealt with the distinction between straight and cumulative voting of shares in the election of directors. That distinction is not a complex one.

> In voting for directors, each voting share has as many votes as there are

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results similar to that in the *Mills* case. *Mills* specifically relied upon *Herrick.*

5. Cason v. State, 16 Ga. App. 820, 829, 86 S.E. 644, 649 (1914).

6. 231 Ga. 872, 204 S.E.2d 622 (1974). For a discussion of this case, see Claxton, *Annual Survey of Georgia Law: Agency and Business Associations,* 26 MERCER L. REV. 21, 31 (1974).

7. 132 Ga. App. 12, 207 S.E.2d 570 (1974).

8. *Id.* at 13, 207 S.E.2d at 572.

9. 232 Ga. 806, 209 S.E.2d 157 (1974).

directors to be elected, i.e., if five directors are to be elected, each share has five votes. Unless the cumulative voting right has been given shareholders by constitution, statute, charter or by-law, the five votes in our illustration can be voted one each for five nominees but cannot be cumulated so as to give more than one vote per nominee. If the shareholders have the cumulative voting right each shareholder may multiply the number of shares (votes) he is entitled to cast by the number of directors to be elected and may then give the total votes to one or more nominees in any proportion he desires.[10]

Georgia does not provide for cumulative voting "unless such voting is expressly authorized in the articles of incorporation."[11] In *Givens*, the court noted that

> [t]he trial judge ruled that the appellee, who owned 650 shares of the voting stock of the corporation as opposed to appellant's ownership of only 350 shares, could cast his 650 votes for each of the corporate directors to be elected, thereby electing all of the directors of the corporation. The appellant [contended] . . . that this method of voting amounted to cumulative voting, that cumulative voting was not provided for in the articles of incorporation, and that the trial judge's ruling was erroneous.[12]

The supreme court quite correctly concluded that the voting procedure in question "was not cumulative voting, and appellant's contention that it was such is without merit."[13] The only surprising aspect of the *Givens* case is that the appellant's attorneys could have so thoroughly misunderstood the meaning of cumulative voting.

C. *Preemptive Rights*

Preemptive rights give shareholders "the privilege to purchase in proportion to their holdings new issues of stock by the corporation before the stock is offered to the public. . . ."[14] Unfortunately, preemptive rights provide little comfort to a shareholder who for some reason — commonly a lack of money — does not wish to exercise those rights. Although there are supplementary methods for protecting the equity interests of shareholders,[15] they are frequently overlooked when documents of incorporation are prepared. In such a situation, a shareholder must exercise one of two unattractive options. He may simply accept the dilution of his ownership interest. This is what will occur most of the time. In the alternative, the shareholder may bring a judicial challenge to the issuance of the new stock.

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10. N. LATTIN, THE LAW OF CORPORATIONS 354 (2d ed. 1971).
11. GA. CODE ANN. §22-608(d) (Rev. 1970).
12. 232 Ga. at 806, 209 S.E.2d at 157.
13. *Id.* at 807, 209 S.E.2d at 158.
14. F. O'NEAL, CLOSE CORPORATIONS: LAW AND PRACTICE §3.39, at 42 (1971).
15. O'Neal suggests "a charter clause prohibiting without the unanimous consent of the shareholders any increase in the amount of capital stock or any allotment or reissuance of stock." *Id.* at 45.

Such a challenge must be based on the theory that the issuance was not undertaken for a proper corporate purpose.

Just such a matter was argued in the case of *Tallant v. Executive Equities, Inc.*[16] That case involved a new issue of voting stock that led to a shift of control from the former controlling shareholder to another individual who was serving as the president and as a director of the corporation. The old controlling shareholder, who for unstated reasons voluntarily chose not to exercise his preemptive rights, insisted that the issuance of the stock "was not for a corporate purpose but solely for the benefit of the board of directors who desired to perpetuate themselves in office."[17]

Various affidavits and depositions made it clear that one purpose of the new issue was to oust the original controlling shareholder from his position. In addition, however, the directors apparently felt that a broadening of the shareholder base (a goal which the new issue really did not bring about) was important for the overall welfare of the corporation. Moreover, the financing to be obtained through a new issue of voting stock was deemed by the directors to be absolutely necessary in order to meet the substantial interest burden carried by the corporation. There was fear of an imminent threat of foreclosure.

The Georgia Supreme Court concluded that the mere fact that a shift of control would result from the new issue was "not material to our decision without some firm evidence that the transaction was fraudulent."[18] The needs to raise capital and to create a broader shareholder base were held to be a sufficient corporate purpose.

D. Rights Of Dissenting Shareholders

A shareholder who dissents from a corporate action approved by the necessary majority of his fellow shareholders has a traditional right to demand that the corporation purchase his shares for their fair value. Such a provision may be found in both the present[19] and the former[20] Georgia Corporations Codes. Under the existing code, the dissenting shareholder must file his demand for payment within twenty days after receiving notification from the corporation of the approval of the action in question.[21] Under the old code the shareholder was required to make his demand within twenty days after the vote approving the corporate action.[22] In addition, the old code provided that once a demand for payment was made, the individual involved "shall cease to be a stockholder in the corporation in which he held a stock and shall have no rights with respect to

16. 232 Ga. 807, 209 S.E.2d 159 (1974).
17. *Id.* at 809, 209 S.E.2d at 160.
18. *Id.* at 810, 209 S.E.2d at 161.
19. GA. CODE ANN. §22-1202 (Rev. 1970).
20. Ga. Laws, 1937-38, p. 214, *repealed by* Ga. Laws, 1968, p. 565.
21. GA. CODE ANN. §22-1202(c) (Rev. 1970).
22. Ga. Laws, 1937-38, p. 233.

such stock except the right to receive payment therefore. . . ."[23] The present law contains comparable language.[24]

Aaron Rents, Inc. v. Corr[25] dealt with the old code's version of the statutes discussed above. In *Aaron Rents*, the dissenting shareholder was three days late in making his demand for payment. Nevertheless, the corporation made no protest and in fact offered to pay three dollars per share (a substantial profit) for the shareholder's stock. The shareholder delayed in accepting the money, however, and ultimately sought to have the benefit of the rights he would have enjoyed as an owner of stock. These rights included the issuance to him of certain new stock to which he would have been entitled as an ordinary shareholder.

The corporation declined to recognize any rights of the shareholder except to receive payment for his stock, and sought a declaratory judgment that its position was correct. Ironically, the shareholder thus found himself in the position of arguing that the corporation's waiver of the twenty-day time limit for the payment demand was ineffective. The court of appeals held that the waiver was effective and that by demanding the right to have his stock purchased, the shareholder had given up all other rights.

E. Inspection Rights Of Shareholders

For the second time in three years, the case of *Master Mortgage Corp. v. Craven*[26] appeared before the Georgia Court of Appeals during the current survey period. In its original opinion, the court had held that a shareholder's attempt to inspect assorted corporate records was too broad in its scope. The shareholder was deemed to have failed to satisfy the requirement that the specific items he demanded to see must have some relevance to his "interests as a shareholder."[27] The shareholder had simply gone too far in his demands, including, among other things, a reference to "all . . . [the] corporate books, records and files pertaining in any way to the business or financial status of the corporation at any time since its inception."[28]

On remand, the trail court restricted the request for inspection in various particulars, and then proceeded to grant it. The corporation appealed. On its review of the case, the court of appeals was confronted with several issues. The most important of these, however, was whether a shareholder must begin anew by making another demand for inspection when the appellate court finds (as occurred in the first *Master Mortgage* opinion)

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23. *Id.* at 235.
24. GA. CODE ANN. §22-1202(d) (Rev. 1970).
25. 133 Ga. App. 296, 211 S.E.2d 156 (1974).
26. 132 Ga. App. 404, 208 S.E.2d 158 (1974). The case was initially reviewed in Master Mortgage Corp. v. Craven, 127 Ga. App. 367, 193 S.E.2d 567 (1972). The original opinion was discussed in Claxton, *Annual Survey of Georgia Law: Agency and Business Associations*, 25 MERCER L. REV. 21, 37-38 (1974).
27. 127 Ga. App. at 371, 193 S.E.2d at 570.
28. *Id.* at 369, 193 S.E.2d at 569.

that the trial court did not sufficiently restrict or limit the right to inspection. The court held that since it had specifically ruled, in the first *Master Mortgage* opinion, as to the manner in which the inspection should be restricted and limited, there was no error in granting the shareholder's right of inspection without requiring him to make another demand upon the corporation.

The position of the court of appeals was logical and reasonable. The erection of technical barriers to the very basic right of shareholders to inspect corporate books and records should not be encouraged.

F. Stock Options

For many corporate executives, stock options represent very attractive supplementary means of compensation.[29] However, the right to exercise a stock option is usually contingent upon certain conditions established by the corporation, and these conditions sometimes present serious obstacles to the holder of the option. One of the most common limitations placed on stock options when they are used to attract new executive talent is that the holder of the option must remain in the continuous employ of the corporation for a certain period in order to exercise his option rights.

The effect of such a condition was examined in *Lowe v. Royal Crown Cola Co.*[30] In *Lowe*, the continuous employment provision in the stock option agreement was coupled with the statement that the employee in question (a new senior vice president) would serve "at the pleasure of the Company and without restriction on the right of the Company to terminate Optionee's employment at any time."[31] The employee was forced to resign within less than twelve months after he was employed, but nevertheless sought to exercise his stock option. The employee argued that the continuous employment provision put

> too much control in the hands of his employer, who could at any time unilaterally defeat plaintiff's [the employee's] expectations under the stock option agreement by discharging him within twelve months after the agreement was signed.[32]

In effect, the Georgia Court of Appeals responded to this argument by concluding that the employee could read, and must live with the terms he had accepted.

Interestingly, *Lowe* was a case of first impression in Georgia. As the court noted,[33] however, there are numerous cases in other jurisdictions which

29. It should be noted that stock options have declined somewhat in popularity during the last decade due to certain changes in the tax laws. However, they are still widely used. For an excellent article on various aspects of stock options, see Vernava, *Stock Options: Corporate, Regulatory and Related Tax Aspects*, 30 U. PITT. L. REV. 197 (1968).

30. 132 Ga. App. 37, 207 S.E.2d 620 (1974).

31. *Id.* at 38, 207 S.E.2d at 622.

32. *Id.* at 41, 207 S.E.2d at 624.

33. *Id.* at 42, 207 S.E.2d at 624.

have reached the same result on similar fact situations.

G. *Procedure*

In *Mousetrap of Atlanta, Inc. v. Dekle*,[34] the defendant corporation made a special appearance to argue that service of process was not properly made on its registered agent. While the special appearance was still pending, judgment was entered against the corporation on the basis that it had filed no answer to the compaint. The corporation filed a motion to vacate the judgment. This motion was overruled, and on the same day an affidavit was filed which showed that service had been correctly made. The corporation also withdrew its special appearance in which it alleged lack of service. Nevertheless, it appealed the judgment against it.

The court of appeals upheld the action of the lower court. In the words of the *Mousetrap* opinion:

> Any error committed by the trail court in entering judgment . . . against the corporate defendant while such corporate defendant's special appearance for the purpose of contesting service was still pending must be considered harmless in view of the fact that it was established that service was made upon the proper agent of such corporate defendant and the corporate defendant acted to withdraw its special appearance made in such connection.[35]

This result was in compliance with the Georgia Code, which states that "[t]he court at every stage of the proceeding must disregard any error or defect in the proceeding which does not affect the substantial rights of the parties."[36]

H. *New Legislation*

Several very specific but relatively minor changes were made in the Georgia Corporations Code[37] by the 1975 session of the General Assembly. Provision was made for documents that have been presented to a superior court judge to be corrected by articles of correction when such documents contain errors.[38] For the purpose of determining venue in a tort or contract action involving a corporation, the corporation shall be deemed to reside in the county in which the contract was made or is to be performed, and in the county in which the tort cause of action originated, if the corporation transacts business in that county.[39] Shares of stock which are subordinate to authorized shares of any other class or series with respect to dividends or amounts payable on liquidation must now contain on their face or back

34. 131 Ga. App. 758, 206 S.E.2d 562 (1974).
35. *Id.* at 758-59, 206 S.E.2d at 562-63.
36. GA. CODE ANN. §81A-161 (Rev. 1972).
37. GA. CODE ANN., tit. 22 (Rev. 1970).
38. Ga. Laws, 1975, p. 583 at 586.
39. *Id.* at 588.

a clear and concise statement of the fact of subordination.[40] Elaborate new procedures have been established for situations in which the shareholders seek to act by written consent rather than through a formal meeting.[41] An executive committee of as few as two directors, rather than the three that were previously required, is now permitted.[42] Among other topics regarding which some revisions were made are the deposit with the Department of Administrative Services of amounts due to unknown creditors,[43] the filing of annual corporate reports,[44] and the filing of certain documents.[45]

In general, the changes in the Georgia Corporations Code are purely technical in nature. They do not alter the basic nature of the Corporations Code.

III. SECURITIES REGULATION

A. *The Meaning Of "Security"*

The issue of whether or not something is a security is fundamental to a determination of the applicability of both federal and state securities laws. In the words of one authority:

> One of the first questions which should occur to the attorney whose client proposes to raise funds by the sale of pieces of paper or other property interests is whether those pieces of paper or interests are *statutory securities* within the definition of the Securities Act of 1933 or governing state blue sky laws. If the answer to that question is in the affirmative, the registration (and other) requirements of the federal and state securities laws may or may not come into play, depending upon whether there is a "sale" or "offer to sell" that security, whether the security is an *exempt* security or, although not exempt, whether it is to be sold in an *exempt transaction*. But the significant point is that the careful attorney should address himself first and foremost to the problem of whether the pieces of paper or interests in question are "securities."[46]

In *Jaciewicki v. Gordarl Associates, Inc.*,[47] the Georgia Court of Appeals considered the meaning of the term "security" as it was defined in the Securities Act of 1957,[48] which was recently replaced by the Securities Act of 1973.[49] The judicial tests discussed in *Jaciewicki* are almost certainly

40. *Id.* at 589.
41. *Id.* at 590.
42. *Id.* at 592.
43. *Id.* at 597.
44. *Id.* at 599.
45. *Id.* at 600.
46. 11 H. SOWARDS, BUSINESS ORGANIZATIONS §2.01 (1974) (emphasis in the original).
47. 132 Ga. App. 888, 209 S.E.2d 693 (1974).
48. Ga. Laws, 1957,pp. 134, 136.
49. GA. CODE ANN., tit. 97 (Supp. 1974). For discussions of the new act, see Claxton, *supra* note 26, at 44; Trotter & Poe, *A Survey of the Georgia Securities Act of 1973*, 10 GA. ST. B. J. 219 (1973) *and A Survey of the Georgia Securities Act of 1973: Addendum*, 25 MERCER L.

still applicable to the meaning of security within the 1973 Act,[50] even though the statutory definition found in that act is more elaborate than the language of the 1957 Act.

According to the position of the court of appeals in the *Jaciewicki* case, Georgia has no single judicial test for determining what is a security. Instead, there are at least four possible tests, and they

> are not exclusive of each other. Thus, a factual situation which falls within the framework of either of the tests, or any combination thereof, will afford sufficient basis for a finding that a "security" is involved within the meaning of the statute.[51]

The tests themselves are all familiar to securities lawyers. They include the *Joiner*, *Howey*, Risk Capital, and Managerial Efforts tests. The *Joiner* test is derived from the case of *SEC v. C.M. Joiner Leasing Corp.*,[52] in which it was held that the meaning of a security was to be based on "what character the instrument is given in commerce by the terms of the offer, the plan of distribution, and the economic inducements held out to the prospect."[53] The *Howey* test was set forth in *SEC v. W.J. Howey Co.*,[54] which states that

> an investment contract [security] for purposes of the [1933 Federal] Securities Act means a contract . . . whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party. . . .[55]

The so-called Risk Capital test was developed by the California Supreme Court in *Silver Hills County Club v. Sobieski*,[56] which looked to a situation in which promoters solicited risk capital to establish a business for profit. Any financial benefits to be obtained arise only because the individual investor risks his capital along with other purchasers. Finally, the Managerial Efforts test relied upon in *SEC v. Glenn W. Turner Enterprises, Inc.*[57] mandates the finding of a security whenever "the essential managerial efforts which affect the failure or success of the enterprise" are those of the seller rather than the investor.[58]

In *Jaciewicki*, the Georgia Court of Appeals dealt with whether certain "Distributor Agreements" fell within the definition of security. If so, the defendant had failed to properly register them. The trial court held that

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REV. 601, 625 (1974).

50. *See* GA. CODE ANN. §97-102(a)(16) (Supp. 1974).

51. 132 Ga. App. at 892-93, 209 S.E.2d at 696.

52. 320 U.S. 344 (1943).

53. *Id.* at 352-53.

54. 328 U.S. 293 (1946).

55. *Id.* at 298-99.

56. 55 Cal.2d 811, 13 Cal. Rptr. 186, 361 P.2d 906 (1961).

57. 474 F.2d 476 (9th Cir. 1973).

58. *Id.* at 483.

the agreements were not securities, and entered summary judgment for the defendants. The court of appeals reversed, concluding that the record did not reveal that there were no genuine issues as to any material fact.

B. Alternative Remedies

In *Turpin v. Wilson*,[59] the court of appeals dealt with another matter arising under the old Securities Act of 1957. The court held that a purchaser of securities[60] who might otherwise be barred from recovery by reason of being considered a participant in a transaction that violated the Georgia securities laws could recover the amount paid a seller who fails to deliver the securities for reasons beyond the seller's control, if the recovery was based on a theory of money had and received rather than rescission of the purchase agreement.

In the prior case of *Nash v. Jones*,[61] the Georgia Supreme Court had considered the question of

> whether a participant serving as an officer and director of a corporation at the time stock of the corporation is issued can recover the sums paid by him for a portion of said stock under the purchaser's remedies section of the Georgia Securities Act [of 1957] because said stock was not properly registered in accordance with the Act.[62]

Holding in the negative, the supreme court stated:

> The clear terms of the purchasers' remedies section provides every director or officer who participated or aided in any way in making a sale of securities in violation of the Georgia Securities Act [of 1957] shall be jointly and severally liable to the purchaser. Thus, the plaintiff, *by the terms of the statute under which he seeks to recover*, is equally as guilty of violating the Georgia Securities Act as is the individual defendant . . . . Thus the plaintiff, being in pari delicto with the defendants, cannot recover the sums he paid for the stock issued in violation of the Georgia Securities Act.[63]

The *Nash* decision was not applicable in *Turpin*, however, because the plaintiff in *Turpin* did not rely upon the rescission theory set forth in the statute. Instead, the action in *Turpin* was based on a theory of money had and received. The 1957 Act provided that nothing in it was intended to "limit any statutory or common law right of any person in any court for any act involved in the sale of securities."[64] Thus, the plaintiff in *Turpin*

59. 133 Ga. App. 239, 211 S.E.2d 316 (1974).
60. The actual purchaser in *Turpin* was the plaintiff's decedent.
61. 224 Ga. 372, 162 S.E.2d 392 (1968).
62. *Id.* at 374, 162 S.E.2d at 393-94. For the purchaser's remedies under the 1957 Act, see Ga. Laws, 1957, p. 161.
63. 224 Ga. at 375, 162 S.E.2d at 394 (emphasis added).
64. Ga. Laws, 1957, p. 161.

was perfectly entitled to follow an alternative, non-statutory path to obtain a remedy.

It should be noted that the Georgia Securities Act of 1973 contains provisions that parallel those which were critical to the outcome of both the *Turpin* and *Nash* cases. Therefore, those cases are still quite significant even though a new act has replaced the one with which they dealt.

IV. Fair Business Practices

The Fair Business Practices Act of 1975[65] was enacted by the last session of the Georgia General Assembly. According to the Act, its purpose is "to protect consumers and legitimate business enterprises from unfair or deceptive practices in the conduct of any trade or commerce in [Georgia]. . . ."[66]

The new legislation contains a lengthy but expressly non-exclusive list of unlawful acts and practices.[67] It provides for the appointment of an Administrator and a fifteen-member Consumer Advisory Board,[68] and gives the Administrator the power to seek equitable relief[69] and general damages[70] (on behalf of injured persons) against any violator of the act. Private actions for equitable relief and general and exemplary damages are expressly authorized.[71]

The Fair Business Practices Act has many good features. Unfortunately, however, it is probably not tough enough. To be completely effective the Act should authorize criminal penalties, at least for obviously wilful misconduct. It is true that, at the national level, the Federal Trade Commission Act does not provide for such penalties. However, the Sherman Act does, and Georgia needs equivalent strength in its laws.

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65. Ga. Laws, 1975, p. 376.
66. *Id.* at 376-77.
67. *Id.* at 378-79.
68. *Id.* at 380.
69. *Id.* at 384.
70. *Id.* at 385-86. The Administrator is expressly prohibited from seeking punitive damages in his representative capacity.
71. *Id.* at 386.