Empire College School of Law
Professor Viveka A. Rydell
Business Organizations – Midterm
Fall 2013 Issue Outline

MIDTERM EXAM – **Issue Outline**

(**Grading note:** The whole exam was structured to be overly broad, to allow students to be able to pick up points in areas they know best; they do NOT have to answer all of the answers, or fully. We did go over all of the below concepts in the class Review)

PART I (50 POINTS)

1. **The six issues you should address with Greg, Melinda and Bert (and/or ask yourself, as their lawyer) in determining which business organization form to recommend to them are:**
   a. What is required to form & operate the business (<u>requirements</u>)
   b. <u>Who will manage</u> the business & how will business decisions be made,
   c. To what extent will the investors be <u>personally liable</u> for the company's obligations,
   d. How will the business be <u>financed</u>?
   e. How do investors receive a <u>return on their investment</u>?
   f. The <u>tax consequences</u> of forming a business?

2. **Some of the Business Organizations in the United States that Greg, Melinda and Bert can choose from are:**

   <u>Publicly held companies</u> – they can't choose from these yet, but here they are: (company does not – yet- have shares traded on the a securities stock)
   a. General Corporations
   b. [some Limited Partnerships]

   <u>Privately held companies</u>
   g. Sole Proprietorship
   h. General Partnership
   i. Limited Liability Companies
   j. General Corporations
   k. Closely held corporations
   l. Professional corporations (members of licensed profession: doctors/lawyers)
   m. Limited Liability Partnership

(**Comment**: Extra points for dividing them into public versus privately held).

3. **Some factors for them to consider in choosing what type of business organization to conduct business as (drawbacks and benefits of each business organization listed above) are:**

(**Grading note:** This is a way for students to pick up points; they do NOT have to answer all of these)

<u>Publicly held companies</u> (**Advantage** for all publicly held: of ease of selling your interest as it is has a "ready" value on the public stock exchange)

a. General Corporations.

  a. **Advantages:**

    (1) Flexible capital structure
    (2) Centralized management structure
    (3) Trad'l structure provides substantial flexibility as Directors can decide how much authority to retain & how much to delegate to Officers
    (4) Perpetual life of company
    (5) Well-established form for all types of businesses

  (Or the following/**Extra Points**: Management structure: Shareholders, Directors & Officers; Shareholders passive investors of capital, elect directors & approve certain extraordinary corporate actions; Votes usually allocated on a per-share rather than per capita basis, so voting power is directly tied to amount of capital contribution; Directors, acting as a board, set policy & either manage or direct management of the corp; Authority of Board is restricted only by shareholders' limited powers (vote new Director to replace); Directors elect officers, who manage the day-to-day operations of the corporation in whatever ways the directors authorize.)

  b. **Disadvantages of the Corporate Form**

    (1) **Expenses** and trouble of formation & maintenance (bd meetings, minutes, proper record keeping)/Required initial & continuing formalities
    (2) **Tax treatment** (**double taxation**; corp taxed; & shareholders taxed on dividends like income) – other ways to minimize taxes (reinvesting available cash & paying salaries to their owner-managers; expenditures for

officers/employee benefits are deductible to the corp, & not taxable to recipient)

b. Limited Partnerships. **Advantage:** Voluntary Agreement entered into by 2 or more parties wherein 1 or more general partners are responsible for the enterprise's liabilities management, & other partners are liable only to the extent of their investment.

Privately Held (**Disadvantage** for all privately held: difficulty of selling your interest as it is has a "ready" value on the public stock exchange).

c. Sole Proprietorship – **In this scenario**: will not be able do to (since they are more then one individual). **Disadvantage**: Exposure to liability (if you don't take out liability insurance you could be in trouble); if your business grows and you want to add more employees/management/investors. **Advantage**: easy to set up and very flexible as you control and manager your own business.

- General Partnership – **Advantages**. Pass-through taxation. Flexibility. It is essentially a contractual organization: Partners can contract with each other and basically set up the kind of organization they want, and limit liabilities or duties; although fiduciary obligations are central component of partnership law

d. Limited Liability Companies – **Advantage**: Limiting personal liability. Pass-through taxation.

e. Closely held corporations – **Advantages**: Sometimes allowed greater latitude than publicly held corporations in their internal management; Shareholders stand in a fiduciary duty relationship to each other.

f. Professional corporations (members of licensed profession: doctors/lawyers) **Disadvantage**: not available to those who are not members of a licensed profession, or setting out to conduct that profession (cannot use for *Sonoma Escapes)*

g. Limited Liability Partnership. **Advantage**: Limiting personal liability. **Disadvantage**: Ownership interest may be harder to sell than to simply sell your stock on the public stock exchange.

4. **Two ways in which Bert can receive a return on his investment are:**

   a. He can receive a portion of *Sonoma Escapes'* profits (when/if they have any), or
   b. He can sell his interest in *Sonoma Escapes*.

   (**Extra points**: Bert could see if someone else would want to buy his percentage interest in *Sonoma Escapes*, dollar value of which could possibly be based on the value at that time of:
   - Revenue
   - projected income
   - good-will
   - brand recognition of the company.)

5. **The legal doctrine that can help Melinda is** the DUTY OF LOYALTY.

Definition: This duty is the Director's Duty to refrain from self-dealing or take a position adverse to the corporation's best interests.

The three subsidiary obligations of the Duty of Loyalty are:

a. To refrain from competing w the Principal, or taking action on behalf of/otherwise assisting Principal's competitors;
b. Not to acquire a material benefit from a 3d party in connection w actions taken through the agent's use of its position, and
c. Not to use or communicate confidential information of the principal for the agent's own purpose or those of a 3d party.

PART II (50 POINTS)

1. LIMITED LIABILITY refers to limitations placed on business owners' personal responsibility for the debts and obligations of their businesses. If a business organization provides owners limited liability, creditors cannot look to the business owners' personal assets to satisfy business debts and obligations.

2. PIERCING THE CORPORATE VEIL refers to the legal doctrine of <u>not</u> shielding from personal liability <u>because of the wrongful acts</u>. <u>Factors considered</u> in deciding whether to "pierce the corporate veil" include:

(**Grading note**: 4-6 are sufficient to list, but below list is more exhaustive, for the students who can get extra points).

a. Absence/ inaccuracy of corporate records;
b. Concealment or misrepresentation of members;
c. Failure to maintain arm's length relationships with related entities;
d. Failure to observe corporate formalities in terms of behavior and documentation;
e. Intermingling of assets of the corporation and of the shareholder;
f. Manipulation of assets or liabilities to concentrate the assets or liabilities;
g. Non-functioning corporate officers and/or directors;
h. Significant undercapitalization of the business entity (capitalization requirements vary based on industry, location, and specific company circumstances);
i. Siphoning of corporate funds by the dominant shareholder(s);
j. Treatment by an individual of the assets of corporation as his/her own;
k. Was the corporation being used as a *façade* for personal dealings; *alter ego* theory.
l. Failure to pay dividends.

3. The difference between a limited partnership and a limited liability partnership are:
    a. **LIMITED PARTNERSHIPS:** Voluntary Agreement entered into by 2 or more parties wherein 1 or more general partners are responsible for the enterprise's liabilities & management, & other partners are liable only to the extent of their investment.
    b. **LIMITED LIABILITY PARTNERSHIP** (LLP) different: shields all partners from personal liability!

4. Circumstances for a Principal being liable for an Agent's TORT are:

    a. If the Agent's with actual or apparent authority of principal ratifies agent's acts,
    b. If principal is negligent in choosing a supervising agent,
    c. If agent fails to perform a duty to act carefully that has been delegated to the agent
    e. Acts of employee acting within scope of employment

(**Extra Points**: important fact to look at is issue of whether the conduct was "within the Scope of Employment"; Papa John's/"The Pizza Case" is a seminal case. Also can mention cases of angry bus driver attacking another motorist (no); store clerk shooting robber (yes); car sales man shooting out tires on car being stolen (yes).

5. DUTY OF LOYALTY is a Director's Duty to refrain from <u>self-dealing</u> or take a position <u>adverse</u> to the corporation's <u>best interests</u>.

6. The four forms of Corporations are:

    a. <u>Public</u> (Airport authorities) – formed by special legislation or Act, or by Secretary of State
    b. <u>Government</u> (AmTrak, USPS)
    c. <u>Non-profit</u>
        a. Charitable (benefits another group; i.e. hospitals, universities & charities)
        b. Mutual-benefit (benefits its members, i.e. social clubs; the organization escapes taxation on its profits, but contributions to NP are not IRS deductible by donor)

d. Business
   a. Publicly Held Corporation (shareholder views himself primarily as owner of shares, not of the corp)
      i. Securities Exchange Act (SEC public filing requirements); "I own some Microsoft stocks"
   b. Closely Held Corporation (shareholder takes personal, long-term interest in corp; Non-reporting; "I own a piece of that business")

(**Extra points**: sub categories, and examples.)

7. The BUSINESS JUDGMENT RULE is: A Corporate Officer who makes a mistake in judgment as to economic decisions, consumer tastes, or production line efficiency will rarely, if ever, be found liable for damages suffered by the corporation. (**Extra points**: for listing case name, like Joy v. North.)

8. Yes, a JOINT VENTURE is similar to Partnerships. (**Extra points**: It is often organized to complete a specific project, like developing a particular piece of real estate, rather than engage in an ongoing enterprise.)

9. No, an Attorney may not settle a case without his or her client's approval. (**Extra points**: Koval & Koval).

10. Both terms refer to how business organizations are taxed:

    a. "Double Taxation Scheme" is when first the corporation is taxed; and then second, shareholders are taxed on dividends they receive (income tax). (Extra points: Corporations, and LLC's who chose to be taxed thus, are subject to double taxation)

    b. "Pass-Through Taxation" is when the company's tax liability passes through the business organization directly to the owners (Taxed Once). (**Extra Points**: Method in which a firm's owners pay income tax on the firm's income and not the firm. Sole proprietorships, S corporations, and partnerships pay tax through this method.)