STUDENT ID________________

Empire College of the Law

Fall Semester 2011

Business Organizations

Midterm Examination

December 5, 2011

Professor: Rob Rutherfurd

Three Essay Questions

Time to Complete Examination: 3 hours

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Instructions

This midterm examination consists of 3 essay questions. Your answers to each question will be weighted equally when determining your grade. You have three (3) hours in which to complete the exam. The recommended time for each question is one (1) hour. Please budget your time so you can adequately answer each question.

Before starting to write, you should read each question carefully and spend some time organizing your answer. Your goal should be to identify the issues, recite applicable law and then apply and analyze the facts. Strive for precision and brevity and avoid getting stuck on one issue or topic.

Good Luck. Happy Holidays.

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Business Organizations - Midterm
Monday, December 5, 2011

Question 1

Sue loves to bake bread and dreams of starting a commercial bakery. Sue tells Pam, a business consultant, about her idea, and Pam offers to help. Though nothing is put in writing, they agree that Sue will pay Pam 15% of the proceeds from the sale of Sue's bread. Pam says her friend Keith has some extra money he wants to invest. Sue and Pam speak with Keith, and he agrees to loan the business $100,000. They do not discuss repayment terms, but Sue agrees that the business will pay Keith 25% of the annual net profits and that Keith must approve any expenditure over $10,000.

Sue asks Pam to look into the requirements for starting the bakery, but reminds Pam not to commit to anything without checking with her first. Pam contacts Joyce about designing packaging and a logo for Sue's bread. The next day, Sue joins a conference call with Joyce and Pam, during which Joyce describes her ideas for the packaging and logo. Sue thanks Joyce for the information and says she has to go to another appointment. After Sue hangs up, Pam then tells Joyce to get started. Joyce completes the packaging design and the logo and sends Sue an invoice for her services.

Bill, a real estate developer, calls Sue and tells her that a building he recently acquired would be a great location for the bakery. Sue says that she will send Pam to take a look. Pam loves the place. She signs a five (5) year lease as “Pam, agent for Sue.” On the same day, Sue receives a letter from a law firm representing Best Bread, Inc. The letter says that Keith is a director of Best Bread and that his financial relationship with Sue's business violates his fiduciary obligations to Best Bread. The letter closes with a demand that Sue and Keith pay Best Bread $50,000 in damages.

Sue freaks out and decides to abandon her plans. Please discuss what liability Sue faces, if any, arising from these events.

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Question 2

Patty, Shawn and Buddy decide to start a business supplying fuel to airports. They plan to incorporate under the name "PSB, Inc." Patty discovers a fleet of fuel trucks for sale and tells the seller that PSB will buy the trucks once the corporation has been formed. The Seller refuses to hold the trucks without a signed contract, so Patty executes a purchase agreement as" Patty, agent for PSB." The next day, Buddy signs the PSB Articles of Incorporation. The Articles authorize issuance of 1,000,000 shares of common stock with par value of one dollar ($1.00) each.

One week later, Patty, Shawn and Buddy hold an organizational meeting. Lucinda, the lawyer they hired to represent PSB, shows them the original file-endorsed Articles. Buddy, as incorporator, appoints Patty, Shawn and himself as the directors of PSB. The directors appoint Buddy as President and Shawn as Secretary. The directors pass a resolution approving the purchase of the trucks and ratifying the contract signed by Patty. Next the directors issue 100,000 shares of stock to Patty for locating the fleet of trucks, valuing those services at $50,000, and for a $50,000 promissory note from Patty to PSB. The corporation also issues 100,000 shares to Shawn for $100,000 in cash and 100,000 shares to Buddy in return for his promise to work at PSB for at least the next three (3) years. To raise more cash, the directors authorize the issuance of 50,000 shares to Patty's aunt Dora for $25,000. Aunt Dora will not participate in the business.

PSB starts business the next day. Buddy is in charge of training the drivers. In doing so, he omits some critical information; as a result, one of PSB drivers starts a fire at the airport that badly damages a hanger and a private jet. Unfortunately, Shawn, who was in charge of obtaining insurance for PBS, has not done so yet. Before the accident, Shawn in her capacity as Secretary of PSB, but without approval by the other Directors, placed a large fuel order PSB now has no buyer for.

Assuming that PSB can not survive this calamitous start, what personal liability, if any, do Patty, Shawn and Buddy face? On what grounds?

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Question 3

Cesar owned all 300 shares of the issued and outstanding stock of Wolves Lumber, Inc., a California corporation ("Wolves"). Cesar was Wolves' only shareholder. When Cesar died in 1998, he left 100 shares of Wolves stock to David, 100 shares to Conrad and 100 shares to Louie. In 1999, David, Conrad and Louie signed a Management Agreement under which the three of them agreed to vote together and elect themselves as directors of Wolves. The corporation conducts business only in California, and all three of its shareholders reside here.

In 2002, the shareholders amended Wolves' Articles of Incorporation to include the following provision: "The liability of directors and officers to the corporation and its shareholders for breaches of the fiduciary duty of care is limited to fullest extent allowed by law."

In early 2011, a lawyer representing David and Conrad sent Louie a letter saying that the Management Agreement was an unenforceable voting trust and that David and Conrad would no longer honor it. David and Conrad then noticed a special shareholders meeting during which they removed Louie as a director despite Louie's strenuous objection and appointed their friend Erik to replace him. The new Board hired David and Conrad as consultants and awarded them hefty compensation packages, including options to buy an additional 200 shares of Wolves' stock.

A couple of months ago, Wolves' President, Eileen, called a special Board meeting during which she told the Directors that the corporation's lumber storage systems were old, dangerous and violated a number of workplace safety laws. David and Conrad told Erik not to worry about it. Eileen, they said, always raised silly concerns like this. The Directors ignored her report. Six months later an inspector assessed a large fine against Wolves based on the safety issues identified by Eileen.

Louie hires you to advise him about this situation. He wants to know if these actions by David, Conrad and Erik were legal, and if not, what he might do about them. He wants to reclaim his seat on the Board and recover damages from David, Conrad and Erik. Please discuss his potential rights and remedies.