Empire College School of Law
Professor Rutherfurd
Business Organizations – Midterm
Tuesday, December 12, 2017

Student ID#_______________

QUESTION 1
(One Hour)

In January 2016, Nancy, Julie, and Fred inherited a commercial office building from their grandmother. Nancy convinced Julie and Fred to deed their one third interests to a new limited liability company named Friendly Offices LLC (Friendly). Nancy assured Julie and Fred that she would take care of everything concerning the LLC.

One year later, Julie and Fred received the 2016 income tax filings and financial statements Nancy prepared for Friendly. The documents showed that the building had generated a $150,000 profit from rental income in 2016. Julie and Fred each received a K-1 statement requiring them to report and pay taxes on $50,000 of income on their individual tax returns. Friendly had not distributed any of that money to them; instead, Nancy had reinvested all of the profits into a major remodeling. The project got out of hand, and now, having spent all the money it made in 2016, Friendly still owes approximately $100,000 to the general contractor.

There were other surprises and disappointments as well. Though she occupied the prime suite in the building, Nancy paid no rent to Friendly. She also charged Friendly large commissions (Nancy is a licensed realtor) whenever she signed up a new tenant. Nancy does not allow Julie or Fred to participate in any management decisions about the building and refuses to let them inspect the books and records of Friendly.

Investigating these issues, Julie discovered that Nancy never filed Articles of Organization for Friendly with the Secretary of State. Except for their decision to transfer the property into an LLC, Nancy, Julie, and Fred have never entered any agreement among themselves regarding ownership or operation of the building.

Julie and Fred are angry and worried about these developments. They hired you to advise them about their potential rights, liabilities, and remedies under these circumstances. Please do so.

QUESTION 2
(One Hour)

On Jul 1, 2016, Buddy, Sally, and Bill formed "Breaking Cold, Inc." (Cold) by filing Articles of Incorporation with the Delaware Secretary of State. They planned to manufacture an extra strength, non-drowsy, cold-relief medication. The Articles authorized Cold to issue up to 1 million shares of common stock and set the par value at $1,000 per share.

At the organizational meeting, Buddy, Sally, and Bill appointed themselves as the initial directors of Cold. They then adopted a resolution directing the corporate officers to issue 200 shares to Sally for lab equipment valued at $1,500, 100 shares to Buddy for $750 in cash, and 150 shares to Bill for an $1100 unsecured promissory note. Sally also loaned $250,000 to Cold. To document the loan, Cold issued a note to Sally; the note said that the entire loan was payable at any time on demand by Sally.

The value of Breaking Cold's business shot upwards as customers gobbled up the company's product. The accountant for Cold estimated that each share of stock was worth $10,000. The three shareholders hoped to capture this run-up in the stock value by selling some of their shares to family and friends. But no one was willing to pay $10,000 per share, so Buddy and Bill formed "BB, Inc." Buddy contributed his 100 shares of Cold stock to BB for 1 million shares of BB stock. Bill contributed his 150 shares for 1.5 million shares of BB stock. Buddy and Bill did not offer Sally the chance to participate in BB.

This arrangement left BB in control of Cold, as BB owned 250 of the 450 shares of Cold's outstanding stock. But since there were 2.5 million shares of BB stock issued and outstanding, the value of a single share of BB Stock was only $10 as compared to $10,000 for a single share of Cold's stock.

A robust market developed for BB stock, since an investor wanting to participate in Cold's growth could acquire 100 shares of BB stock for $1,000, while buying only 10 shares of Cold stock cost $100,000. That BB controlled Cold made the BB stock even more attractive and Cold stock even less so. Buddy and Bill sold most of their BB stock, making hefty profits while Sally was left holding stock in Cold for which there was no market.

Then the roof fell in. The FDA ruled that Cold's product violated a number of safety standards and ordered stores to remove it from their shelves. Cold was suddenly worthless and was forced to file bankruptcy. Sally has hired you to advise her. She hopes that she can collect at least part of the amount due under the note in the bankruptcy proceeding. She is also looking for reassurance that she faces no personal liability as a result of these events. Finally, Sally wonders if she has any recourse against Buddy and Bill, since they made lots of money selling their BB stock and she is left with nothing. Please respond to her questions.