Business Organizations
Fall 2017 midterm
Model Answer outline
Question one

1. **Did Nancy, Julie and Fred create a business entity that will protect them against debts and liabilities of the business?**
    a. **Rule: Formation Requires filing of Articles with the Secretary of State**
    b. **Members are not personally liable for the entity's obligations**
    c. Rule: Defacto entity maybe recognized where there was a good-faith effort to comply with statutory requirements
        - No serious effort was made to comply with formalities other than deeding the property in the name of the LLC.
        - Modern statutes disfavor or eliminate recognition of defacto entities
    d. Estoppel may apply where third party willingly dealt with entity as if it was validly formed
        - Estoppel might be applicable to the contractor doing the work.
        - But estoppel is an equitable doctrine that a Court may be hesitant to apply in circumstances where little effort was made to comply with the filing requirements
    e. Conclusion: The limited liability company will not be recognized and will not provide liability protection to its members.

2. **Issue: Are Nancy, Julie and Fred partners by default because the LLC was not validly formed?**
    a. **Rule: A partnership consists of two or more persons engaged together in business for profit.**
    b. **Forming a partnership does not require compliance with any statutory formalities.**
        - The three of them shared profits.
        - They clearly meant to engage in business together.
    c. **General partners share joint and several liability for all of the deaths and obligations of the partnership, and they're considered the agents of each other for action taken within the scope of the partnership business.**
        - The three of them share liability for the amount due to the contractor.

3. **Issue: did Nancy breach her fiduciary duty to Julie and Fred.**
    a. **Partners owe each other the highest level of good faith and fair dealing. These fiduciary duties consist of the duty of care and the duty of loyalty**

b. Nancy committed actions that violate rules governing partnerships
   - Exclusion of Julie and Fred from management: each partner entitled to participate and gets 1 vote
   - Charging commissions; not entitled to compensation for partner's services to the partnership
   - **Nancy not paying rent for use of Partnership property; agent or partner can not possess or use property for own purpose**
   - No distributions:Nancy is freezing out the other Partners.

4. **Nancy probably reached the duty of care she owes Julie and Fred by failing to file the articles of organization for the LLC I'm exposing them call to personal liability.**

5. **What remedies may Julie and Fred pursue against Nancy?**
   - **Withdrawal**
   - Partners free to withdraw, Must be bought out if partnership does not dissolve.

   - **Involuntary Dissolution**

   - **Oppressive conduct buy one partner against another justifies and voluntary dissolution.**
   - Is this oppressive conduct?
   - Nancy getting all the benefits at the expense of Julie and Fred.

   - **Damages for Nancy's breach of fiduciary duty, including the commissions she received and the rental value of the partnership property she occupied.**

Question 2

1. **Issue : Does Sally face potential liability for not paying adequate consideration for her stock?**
    - Designating a Par Value is optional in Delaware
    - If included in the articles, Par Value is the minimum amount the corporation may receive for the stock.
    - Difference between amount received and par value is "Watered Stock." The stock is assessable for the difference
    - Sally should have paid $1,000 share; she may be assessed the difference.

2. **Issue: Is Sally's claim under the promissory note likely to be subordinated to other creditor claims and treated as equity?**
    - A shareholder may also be a creditor of the corporation provided that the corporation is adequately capitalized and the debt to equity ratio iss reasonable.
    - Here, nearly all of the capital was contributed by Sally as debt. The corporation was undercapitalized. The court likely will subordinate Sally's debt to the claims of other creditors.
    - Her note lacks definite payment terms and is simply due on demand. That increases the likelihood of subordination.

3. **Issue: is there a danger that the corporate veil may be pierced, leaving Sally, Buddy and Bill personally liable for all the debts and obligations of Cold?**
    - Piercing the corporate veil requires:
        i. Unity of interest between the shareholder(s) and the corporation; and
        ii. Piercing must be necessary to avoid injustice
    - Severe under capitalization satisfies the first issue
    - Will court pierce the corporate veil in interest of justice because of safety violations?
    - The use of a corporate entity to avoid liability for compliance with safety regulations coupled may convince the court to pierce the veil.

4. **Did Buddy and Bill breach their fiduciary obligation to Sally?**
    - Cold was closely held, at least until Buddy and Bill hatch their scheme to create a market for Cold's stock.
    - Shareholders of a closely held corporation owe each other the highest fiduciary standards of good faith.
    - Controlling shareholders may not defeat the reasonable expectations of the minority shareholders.
    - Billy and Buddy accessed the unrealized appreciation of the stock but did not offer Sally the opportunity to participate. They created a

benefit for themselves that they failed to share with her, such action violates their fiduciary duty to her.

5. **Note: Buddy and Bill failed to pay adequate consideration for their shares as well and may be forced to pay the"water" to the bankruptcy creditors.**
    - **The consideration Bill paid– a promissory note– is not sufficient consideration under Delaware law; it is accepted under the Model Act.**