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======== Start of Answer #1 (3427 words) ========

Memo

To: Bert Howell
From: Attny X
Date: December 9, 2013
Re: Sonoma Escapes business venture

Bert, it was a pleasure meeting with you yesterday and hearing about your plans regarding the new business venture. Pursuant to your request, please find below the information regarding this new project.

1. Issues to consider

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• Decision-making

Determining how decisions will be made, and who will have the power to make them, is an important consideration. Management of the business may be centralized, as in a publicly traded corporation, or on a smaller scale, in a manager managed limited liability company (LLC). Conversely, if there are a small number of owners who will also be actively participating in the business, management and decision making may be allocated between the owners. In a member managed LLC, for instance, the default rule is that each has an equal voice in the management of the business. This can be altered by agreement (see below), so that if one or more of the owners is not active in the day to day operations, they might cede some of the authority to the other owners in a partnership agreement, operating agreement or bylaws.

A corollary to this is discussed below-how you will fund growth in the business. For instance, you are starting with 3 owners. It may be that when the business requires additional funds for expansion, there will be funds accumulated in the business to finance it, or a bank may lend you the money based on the track record of the business to date. However, in the event that more capital is required, it can have an unexpected impact on management and control.

Most small business owners want to protect their right to make decisions about the business, and they are particular about who they are in business with. Generally you will want to have protections that cover things such as: a partner/owner who wants out; death of one of the owners; need to bring in more owners or raise capital from existing owners. All of these can be addressed in an agreement up front. Please see Transfers below for more information on this topic.

In a corporate environment, there are various ways that voting can be utilized to either distribute control (via directorships) to include minority shareholders, or to concentrate it with one or more: straight and cumulative voting, class voting and weighted voting. If you decide to form a corporation, we should discuss this in more detail.

- Capital structure

The source(s) of funding for the new business will depend in part on the type of entity chosen (see below). For instance, a corporation offers perhaps the most flexibility as to capital structure, because such things as bonds, public stock offerings and other funding vehicles are more readily available. This is due in part to the long history and settled law surrounding corporations. However, in any case, the key question will be how much debt is used vs. equity. Equity is the capital (cash, past services, assets) that the owners inject, and debt is, as you know, borrowed funds. Depending on the perceived viability of the business plan and the business itself, it may also be possible to obtain angel funding, or venture capital.

The debt can be obtained from a bank, other lender or even one of the partners in the business. However, borrowing from an owner does raise some additional considerations. It is important to observe formalities regarding this debt, including a record of the transaction, an actual promissory note (no handshake deals), a payment schedule that is customary for the type of financing, and treating the owner as a creditor as regards the loan. This means that the creditor/owner should require regular payments, make demand if not paid timely and otherwise act like a creditor. If they fail to do so, in the event of business failure and bankruptcy, other creditors are likely to ask the court for equitable subordination; that is, they will ask the court to treat the 'loan' as an investment. This would mean that the creditor/owner would only get paid if there were sufficient funds left after payment of all third party creditors, because the priority of payments would be creditors, and then owners.

There are benefits and costs to both sides of the debt/equity equation. When the company is more leveraged (higher debt to equity ratio), there is a greater opportunity for higher return on the owners' investment. Essentially they are using others' dollars to make money. However, the risk is also higher-in the event of a business downturn or failure, there is not likely to be funds left after paying creditors, and the initial investment may be lost. There are also increased costs to the business to service a higher load of debt. If the owners use their own funds to capitalize the business, they will reduce their risk, but also the possible rate of return. You and your partners will want to assess your own risk tolerance, and consider the capital needs of the new business. Because you are providing office space rent-free, and the business is not one that requires a large up front investment in equipment or infrastructure, your capital needs will likely be modest initially. You will want to think beyond the initial investment to consider how you will fund growth-by adding employees, additional marketing and possibly more space, for instance. Planning now for this will reduce the possibility of disagreements later over how to raise additional funds, and how that may affect the ownership and control rights of existing owners.

It is important to ensure that the business is adequately capitalized at inception and on an ongoing basis. This is important to maintain any shield from liability for the owners. Undercapitalization is one of the primary factors considered by courts when called upon to pierce the corporate veil (see Liability).

You mentioned that Greg and Melinda are each planning to invest $5,000 in cash, and your investment will be the use of the office space rent free. Greg also will supply contacts and networking skills, and Melinda her design and marketing skills. In most jurisdictions, future services are not consideration for purposes of investment in a business. This is important because there must be adequate consideration paid stock (corporation) or partnership capital. However, any past services, or the fair rental value of the office space you are providing, may be considered in determining if adequate consideration was given. Failure to pay full consideration will result in what is called watered stock, and will expose the individual to liability up to the amount of 'full consideration'.

• Transferability of interest

As noted previously, the owners in a closely held business typically have a strong interest in controlling who else might be able to join the ownership circle. Sometimes Regardless of the type of entity you choose to form, you can establish in your written agreement how these questions will be addressed.

Examples of these arrangements include: buy/sell agreement, which calls for the business or the other owners to buy out an exiting partner/owner; a buyout agreement that mandates buying out of an owner upon a triggering event, such as death; first right of refusal for the other owners so that they can be first in line to buy the interest of the departing owner, or it even can call for dissolution on the event of a death or incapacity of an owner, or some other trigger. This allows for estate planning, resolution of irreconcilable differences and bankruptcy or incapacity of an owner, for instance.

An issue that will arise when an owner leaves is how to value their share of the business. There are four common methods: book value (based on the balance sheet), capitalized earnings method (based on the value of the revenue stream over time), a pre-agreed value based on some sort of index, or obtaining an independent appraisal at the time of the sale. It is best to consider these options and include the method in the agreement.

The effect of these restrictions will be that control will be maintained by the existing owners, but it will also limit your opportunities to raise capital.

If you want to have the capacity to readily buy and sell an interest in the business, a publicly traded corporation will be the vehicle of choice, and as a result, setting up a corporation from the start is advisable.

• Taxation

Setting aside sole proprietorships (available only to single owners and married couples), the tax treatment of the new business will depend on what type of entity you select. Corporations are taxed as an entity, and then individual owners are also taxed on any earnings or dividend income derived from the corporation. This is referred to as double-taxation. Partnerships and LLC's are pass-through entities, and other than a small state franchise fee, they do not pay taxes as an entity, but rather pass the net income through to the owners, who pay taxes individually (they may have other write-offs that reduce their tax liability overall). From this perspective, a corporation is the lesser of the choices, but as you will see, there are other reasons to select a corporation.

• Profits/returns

I understand that Greg and Melinda plan to keep their current positions initially, and that you do not plan to actively participate in the day to day running of the business. However, in time both Greg and Melinda hope to draw a salary and work there full-time. This is one means of obtaining a 'return' on their investment. As owners, you may be able to take distributions or dividends from the company as well. Additionally, you would hope to eventually gain from the sale of your interest in the business, making a return on your initial investment. How much you need/want to pull from the business is a factor to consider. It is possible to alter by agreement the management power and the share of profits of each partner.

As discussed above, you will not want to take dividends that render the business insolvent, or unable to meet its obligations. State statutes will govern as to when a dividend may legally be paid. Courts have used various tests to consider the validity of payment of dividends, such as a balance sheet test, nimble test or other tests.

• Liability of owners

The degree to which the individual owners will be liable for the debts and other obligations of the business is a primary consideration. One of the major reasons for forming a corporation, LLC or a limited liability partnership (LLP), or limited partnership (LP) is to shield the individuals from this very liability. The general rule is that owners in a limited liability entity will not be liable for the debts and obligations of the entity beyond their initial investment. However, there are exceptions to this rule.

General partnerships and general partners in a limited partnership are jointly and severally liable for the partnership's liabilities, whether in contract or tort.

A court may also pierce a corporate veil due to thin incorporation, aka undercapitalization; fraudulent representation by directors; failure to observe corporate

formalities; absence of corporate records; payment of personal obligations with corporate funds (commingling) or use of the corporate form to promote fraud, injustice or illegality. Hence, if a corporation is the form chosen, it is especially important to observe all corporate formalities, keep personal and business finances separate and ensure that the business is adequately capitalized.

If an LLP or LLC is chose, failure to maintain the status of the entity with the applicable Secretary of State will result in the loss of the protection from liability for the owners. While it is possible that in the event of defective incorporation, corporation by estoppel may be a protection to the owners, the doctrine will not protect LLC members and LLP partners. [Corporation by estoppel is the principle that a good faith effort was made to incorporate, and the third party relied on the existence of the corporation (and hence the nonliability of the individuals) in contracting. The court may find that the equities of the situation estop the third party from reaching past the defective corporation and will shield the individuals.]

• Duties of owners

The level of fiduciary duty that each of you will owe to each other will also depend on the type of entity selected. Partners owe the highest duty of good faith and loyalty to each other, to the point that they will need to subordinate their own interests to that of the partnership and other partners. An LLC member will have a somewhat less stringent duty, with the caveat that a majority member will owe a duty of good faith and loyalty to minority owners (and minority owners with a veto power will likewise owe a duty to majority owners in the exercise of that power). Stockholders in a publicly traded corporation owe each other no duty, but stockholders in a closely held company have a duty like that of LLC members.

In a closely held corporation where the directors are also the stockholders, there will also be a duty of care.

• Disputes

While no one likes to think there will be a disagreement leading to a breakup of the business owners, it is wise to consider the possibility ahead of time, and include in the agreement how this will be handled. It might be a result of bad faith or fraud on a fellow owner's part, or simply that you cannot agree on how the business should operate, or where it is headed. If you do not address this in your agreement, you will be subject to the default rules in the statute for the state in which your business is incorporated, organized, or if a partnership, in the state where your principal place of business is located (internal affairs doctrine). It is a better practice to set out for yourselves how you will address this.

Failure to do so may land you in court to resolve the dispute. A court has authority to consider several options, including dissolution, possibly with a buyout option for the remaining owner(s); a provisional director (short term appointment to break a deadlock in a closely held corporation); custodian (to operate the business); receiver (to liquidate the business) or other means.

In an at will partnership, the partnership can be dissolved upon the express will of any partner, with no liability for damages to the exiting partner. If it is a partnership for a term of years or other duration, they can still force the dissolution but may be responsible for damages for their breach.

So you see that it is important to consider these things.

2. Types of entities

Sole proprietorship: This is not legally a separate entity, but is a business operated by a single person (or married couple). Clearly this form is not available nor appropriate

for the three of you.

General partnership: A general partnership requires no formal filings, in fact it can be found even where there is no express agreement. It requires a common enterprise for profit, with an agreement to share the profits and losses. All partners share equally in management and are jointly and severally liable for the debts and obligations of the partnership. This will include torts committed by other partners if within the scope of the partnership (for benefit of) or under apparent authority.

Limited partnership: Requires at least one general partner, who will be personally liable for the debts and obligations of the partnership. It also requires at least one limited partner, whose liability is limited to their investment, but who cannot participate in management. If they do actively participate in management, they will lose their liability shield.

Limited liability partnership: all partners have a liability shield (beyond investment) and all may participate in management. This form is reserved to licensed professionals, such as public accountants, doctors and lawyers.

Limited liablity company: An LLC is either member-managed or manager-managed. If member managed it more closely resembles a partnership in its management structure, and if manager managed, it more closely resembles a corporation. All members are shielded from liability for the LLC's debts and obligations.

Corporations: There are two types that would apply here. A publicly traded corporation is one that is required to comply with SEC filing/reporting requirements, and that is traded on a national exchange such as NASDAQ. This will generally be managed by professional managers who may not be owners, and a board of directors will oversee the affairs of the corporation and the officers. A closely held corporation is typically one with a small number of shareholders, who also manage the corporation. Its shares are not readily marketable as it is not traded on an exchange, and may be restricted by

agreement as discussed in 1 above.

3. Advantages and disadvantages of each type of entity

Sole proprietorship

Advantages: Ease and cost of formation
Disadvantages: Owner's exposure to liability, life is limited

General partnership

Advantages: Ease and cost of formation, No ongoing formalities to comply with
Disadvantages: all partners jointly and severally liable for partnership debts/obligations, duration of life may be limited- easily dissolved by one partner

Limited partnership

Advantages: Low cost of formation, relative ease of formation, allows for silent investors with liability shield
Disadvantages: Requires filing with Secretary of State, general partners jointly and severally liable, duration of life may be limited, easily dissolved by one partner

LLP:

Advantages: available to professionals who previously could not shield the owners from liability
Disadvantages: only available to certain professionals

LLC:

Advantages: management and control by owners, liability shield, may have perpetual

life
Disadvantages: formation cost and formalities, ongoing formalities required

Corporation (closely held):

Advantages: flexible capital structure, management by owners/control, corporation law is well developed/well settled law-makes it easier to plan and avoid undue risk of legal liability, liability shield for shareholders/directors, may have perpetual life
Disadvantages: double taxation, formation and ongoing formalities- incorporation filing, meetings, minutes, records, notice, annual statements, etc

Corporation (publicly traded):

Advantages: most flexible capital structure, centralized management, corporation law is well developed/well settled law-makes it easier to plan and avoid undue risk of legal liability, liability shield for shareholders, perpetual life
Disadvantages: double taxation, formation and ongoing formalities- incorporation filing, meetings, minutes, records, notice, annual statements, etc

4. Return on investment

You can obtain a return on your investment by means of a periodic distribution or upon sale of your interest in the business. You could also consider lending the business money as a creditor rather than investing as an owner. If you are an owner, you have the opportunity to share in any profits, but you also have the risk of shared losses. As a creditor, you have a set return (interest rate), which may be safer but will not increase if the business does well.

This is distinguished from recieving a share of profits, which would be in the form of distributions. You could also draw a salary.

5. Duty of loyalty: this is an agency principle that is applicable to partners to the highest degree (finest punctillio of honor). Each partner owes a duty of loyalty and good faith to the other partners to the extent that they will have to subordinate their own interest to that of the partners (Justice Cardozo in the real estate investment case) for the duration of the partnership at least. Each of the three partners are agents of the partnership, and owe this duty.

This duty includes the duty not to compete, not to act adversely to the partners and not to obtain a material benefit from a third party in connection with their status as an agent/partner.

Here, Bert has received $3,000, which would most likely be considered material. He didn't obtain it directly from the partnership's assets or operations but given that Sonoma Escapes is also doing bicycle tours, it would appear that he did in some way use the partnership to obtain this benefit. He clearly has competed with Sonoma Escapes by accepting payment to do something that the partnership is also doing, in the same market. The competing business is also adverse to the new business in that it takes business away that Bert, as partner, should have brought to the partnership. Thus, he has violated his duty of loyalty.

Melinda and Greg may seek to have Bert disgorge his profits/gains, as a principle of agency is that the agent holds any benefits obtained from third parties in constructive trust for the partnership.

Question II

1.) "Limited Liability" is a term used to define the liabilities of owners or partners for debts or obligations arising from the operation of the business in question.

Limited liability of investors, partners, and/or owners is available, in part, in Limited Liability companies, (LLCs) Limited Partnerships — but only "limited partners" to the extent the limited partners do not attemp to exert management, or control, Limited Liability Partnerships,

(LLPs), and corporations.

(2.) "Piercing the Corporate Veil" is a term used to describe factors which "pierce the corporate veil" of the limited liability of ~~corpor~~ corporate shareholders and expose shareholders and investors to liability for the debts and obligations of a corporation. This equitable exception to the general nonliability of corporate investors may be applied where the corporation is 1) used for a fraudulent purpose, 2) undercapitalization,

3) the corporation has failed to adhere to corporate formalities 4.) failure to keep adequate records, 5.) Corporate funds were used to satisfy personal obligations, 6) fraud, illegality or injustice. (BATZ.)

(3.) A limited partnership differs from a Limited Liability Partnership (LLP) in that limited partnerships have two different types of partners, limited partners — who are merely passive investors without management powers and general (managing) partners. General partners have

management authority but are exposed to liability ~~claims~~ whereas limited partners are not liable for debts and obligations of the partnership (unless) exercising management/control. LLPs, however, have only one type of partner — and all partners have full management/control, (and) limited liability in the partnership, at least to the extent that the LLP adheres to the strict statutory requirements of formation & maintenance.

✓ (4.) A principle is liable for an agent's acts in tort

✓ wherever the agent (1) acts with apparent authority and is ratified by the principle, (2)
✓ the agent fails to perform a delegated act with due care, (3)
✓ the principle was negligent in hiring, or (4) the agent was acting
✓ w/in the scope of employment, or to the benefit of the principle; it is ~~clear~~ established law that the principle is not vicariously liable for agent's acts that are outside the scope of employment.

✓ (PAPA JOHNS.)

(5.) The duty of loyalty is a fiduciary duty owed by certain parties ~~e~~ in many business relationships. In agency, the agent's duty of loyalty includes: the duty not to compete with the principle (Huang Que), the duty not to ~~[illegible]~~ derive a material benefit from a 3rd Party while acting on behalf of the principle, (Karnowski — juke box case), and the duty not disclose confidential principle information to a third party.

A director also owes a duty

of loyalty to the corporation not to compete w/ the corporation (Huang Que, supra), ~~not to claim~~ to refrain from self-~~dt~~ dealing, and to refrain from taking positions adverse to the ~~#~~ corporation.

Partners owe ~~a duty of~~ the first duty of loyalty to one another, to act to the benefit of other partners, subordinating one's own interests, and to inform of potential business opportunities and benefits.

(6.) The FOUR TYPES of CORPORATIONS

include (1.) PUBLIC CORPORATIONS, which serve essentially government functions such as minor municipalities, (ex: airport authority), (2) Government corporations, which are owned by the government and serve a public purpose, such as (ex: USPS or AmTrack.), (3) Nonprofit corporations, such as (ex hospitals) which may be either (a) mutual benefit or (b.) charitable purpose, and (4) Business Corporations, (ex: Walmart.) which may be either (a) publicly-traded — requiring formal...

(Q-2 cont. . .)

✓ ... SEC filing and is publicly traded on the securities stock exchange (or)

(b.) ✓ closely-held which are more informal and function more like partnerships, often w/ greater shareholder power and fiduciary duties.

✓ (7.) The BUSINESS JUDGMENT RULE is a defense to the duty of care of corporate directors ✓ and serves to protect directors from liability ~~with~~ for decisions exercised w/in the valid scope of their directoral duties. Per Business Judgment Rule, directors are protected

from consequences of decisions that ~~that~~ are informed, reasonable, in good faith. Business decisions are presumed informed. Per Business Judgment Rule, directors are liable only for gross negligence, or based on the duty of care to inquire and monitor for failure to make reasonable efforts to stay informed.

✓ (8.) A JOINT VENTURE is a joint business formed by two or more (business) entities, similar to a partnership and ~~[illegible]~~ which may be treated like a partnership, legally, and

receive treatment as a partnership for tax purposes (using pass-through taxation, infra.) ✓

(9.) Negative. An attorney must first consult their client and obtain the client's approval before settling a case, ~~pursuant~~ pursuant to both ethical requirements and principles of agency ✓

(10.) CORPORATIONS ~~face~~ are subject to double-taxation per "double taxation scheme" which ~~[illegible]~~ involve (1.) taxation of corporate profits [and] (2.) taxation (again) of distributions of dividends to shareholders (shareholder earnings)

Whereas all ~~#~~ other business organizations (including S-CORPS.), LLPs, LLCs, sole proprietorships and general partnerships are subject to pass-through taxation, which allows direct taxation of owner profits w/out taxation of the business entity itself.

Well done!

ANOTHER EXAMPLE

2nd MODEL ANSWER

PART I

Bert also acted in direct competion with the Sonoma Escapes Co. the facts state they do bike tours.

Berts action was also aiding the competion which is the transfer of his skill and connections to the completion an act adverse to Sonoma Express.

Berts action was also for his own personal economic benefit under the duty of loyalty he his prohibited from acting to use his talents owed to the Co for his own benefit, Sonoma Escapes can sue Bert for Breach of a duty of loyalty and get restitution for the usurpation of Sonoma Express profits -

Memo to Bert

Issues I am concerned about in your deal with Melinda and Greg. I would like to remind you that partnership property is not owned by the partners as such the "free air port office space" may be an issue for your new partners as well as your existing partners if it is partnership property and not your own. I strongly recommend that you advise your existing partners of the deal you propose so that they have the opportunity to take advantage of the business opportunity or you will likely face a suit from them

for the breach of ^the fiduciary^ duty of due care and loyalty owed to your partners. Please give me a call so that we can set up an appt. to discuss your obligations and liabilities

Look forward to your call

Atty 94C.

Good call!