

1)

===== Start of Answer #1 (2556 words) =====

To: Arthur, Bob, and Christina

From: Lawyer

Date: 9 December 2014

Re: Special Emission Control Reducers Business Formation

---

---

---

Arthur, Bob, and Christina,

Thank you for coming in to see me regarding your questions about forming a business. As a follow up to our in-office discussions, please see my thoughts below.

**1. Retaining DDs lawyer**

The use of DDs lawyer presents some questions and areas of concern. DD is wanting to be an investor in this company and at 25% ownership, he will have a significant voice in the matters concerning its maintenance. Typically, any shareholder maintaining 10%

ownership, or more, is able to call meetings for any purpose. Therefore, he has the ability to significantly impact the business direction and continuation.

By using DD's lawyer, his lawyer will already be acting as an agent for him or any other another enterprise he is already involved in. As an agent, DDs lawyer owes a fiduciary duty of loyalty to DD. This means that he must act in DD's best interests, not to compete, not act adverse to him and possibly make him aware of any opportunities he sees for DD. This is a concern as DD is a partner at the Raceway, a similar business, and is offering the lawyer to assist in the organization of the business. While we hope that the offer is purely generous and kind in nature this is a business and it is important to watch for the best interests of all. It is in my opinion that you use alternative representation in drafting any formal documents, performing any research or signing off on any business decisions.

yes  
Potential  
conflict  
not great

## 2. Forms of Business Entities:

### Items to consider

#### Formation

There are numerous forms of business entities that can be formed and there are key considerations in making such a significant decision. One of the first areas to consider is the formation requirements of your entity. Selecting the appropriate business at the outset will make the process of on-going functionality more manageable. Corporations are a well established entity that works for most forms of business but it does require several formalities in starting up and maintaining the day-to-day aspects. If you are looking for something more informal you could look to a partnership which requires no formalities to start and allows you to get going immediately. So please take into consideration how much front work you would like to handle prior to starting the

Not sure  
client  
knows  
what  
that is

operation of your business.

### Management:

You will also want to consider what kind of management structure would work well for you. There are manager held entities, such as public-corporations or member-managed entities, such as a limited liability partnership, partnership or closely-held corporation. In a member-managed entity, you will have a smaller, more intimate group of individuals running the business as opposed to corporate offices, off-site functions, etc. ✓

### Liability:

Liability is another area of concern in considering which type of business you would like. There are various entities that offer limited liability to officers, shareholders and directors in the event that the entity is sued in which case, only the investment into the entity, and not the personal monies of the investor, would be taken. For instance, DD would like to offer \$100,000 for 25% stake in the business. In the event of a suit, this \$100,000 would be liable, but nothing more. Such entities include LLPs, LLCs, corporations, and to some extent, limited partnerships. ✓

### Financing:

Here, we are looking at where the money to start the business will come from. As DD has laid out, he will contribute \$100,000 but we will need to further discuss this. You can obtain funds from banks, personal loans, selling shares, etc. All of these options are viable but require consideration of the effects. If you accept money from another owner in the business, you will want to make sure there are formalities observed in issuance, just as you would with other investors. You will want to evaluate the equity to debt ratio. Equity is an ownership interest in your business while debt is borrowed money. By selling shares, you will have money in the business but you will then be nice ✓

giving ownership to investors. This is equity. You can also procure loans from banks which will act as a debt and there will be no ownership but you will have to make interest payments. The advantage to this is the interest payments will be a tax deduction. One concern is the idea of thin incorporation or undercapitalization. We want to be sure that there is enough money in the entity so as to keep it afloat and not become insolvent.

### Return on Investment:

Investors will want some sort of return on their investment. You will also want to make sure that the entity is properly leveraged in that potential investors may want a more moderately leveraged business so as to reduce risk of loss or insolvency of the business. Leverage looks to the ratio of debt and equity. The higher the debt, the higher the equity. This equates to more risk which can allow for a better return or complete loss.

### Taxation:

Certain entities offer different tax incentives. Partnerships allow for pass through taxation. This means that the tax paid on any profit flows through the entity to the shareholders. Some entities, however, use a double taxation scheme. This scheme, usually found in corporations, taxes the corporation as well as the shareholders.

### Business Forms

#### Sole proprietorship:

A sole proprietorship is an entity form for one individual or a married couple. With three (possibly four) individuals looking to go into business together, this will not work.

General partnership:

A general partnership is formed upon making an express or implied agreement to enter into a profit making business. It is easily formed but poses difficulties in exiting unless the partnership is at will. There is unlimited liability for the partners, meaning they will be liable for all obligations and debt of the entity, but this liability can be mitigated by insurance. There is flexibility in forming, managing and in the capital structure and there are no formalities required to become an operating entity.

Advantages: Easy to form, no formalities

Disadvantages: Difficulty in exiting partnership, unlimited liability

Nice  
Permit  
throughout ✓

Limited Liability Partnership:

Generally, any partnership is an entity where two or more individuals agree to do business together for the purpose of earning a profit. This business form is relatively new but is becoming popular. An LLP offers limited liability to all partners. This is a shield against liability for all entity obligation except for the initial investment. ✓

Additionally, it allows for a flexible management structure. There are requirements to file annual reports, pay franchise fees and you will need to certify in each state you plan to do business in. This requires sending a letter of good standing from your states qualifying body, paying an additional fee and observing any other requirements that state may have.

Advantages: Flexible management, limited liability ✓

Disadvantages: Initial and on-going filings

Limited Partnership:

This form of partnership offers limited liability to some of the partners but not all. In this

entity, there is a general partner who acts in a management role and there are limited partners that act more like passive investors. The general partner maintains unlimited liability for the corporations obligations but can mitigate the harm of this role by procuring insurance should there be any suit. Limited partners have limited liability for the entities obligations unless they start to take an active role in management at which time they will lose their liability shield. It is required that the entity follow the limited partnership statutes of any states it enters and will also need to certify in any and all states it plans to conduct business.



Advantages: Limited liability to limited partners, centralized management

Disadvantages: Unlimited liability to general partners, need for passive investors to remain passive to protect liability shield



Joint Venture:

Stemming from a partnership, this form comes into being by an express or implied agreement to enter into business for a limited purpose. Usually, two already formed business or persons come together for a specific project, not as a continuing form. This most likely will not be something you choose.



Advantages: Easy to form

Disadvantages: Not on-going



Limited Liability Company:

This hybrid entity combines aspects of corporations and partnerships to form a limited liability entity with favorable tax treatment. This is a very flexible in the sense that it can be used for many different types businesses, small and large. It can be a member-



managed format, like a partnership, or a manager-managed entity with a more formal management structure like a corporation. There are filing requirements and all corporate filing requirements as well as capital contributions accounted for in order to maintain the status and the limited liability shield.

Advantages: Limited liability, pass-through taxation, flexible management ✓

Disadvantages: Initial and on-going formalities/filings

#### Corporation:

A corporation is a very structured and established business form. The laws surrounding this entity are sufficient and it can work for most business forms. Centralized management, flexibility in capital structure and limited liability are all advantages.

Double taxation, as mentioned above, is a disadvantage to this form. Two forms of corporations that would work for your business purpose are public-corporations or closed-corporations. While fundamentally similar in their formalities, these two entities differ in their management and financial structures. Public-corporations tend to be larger with centralized management and are registered with the SEC and typically traded on an open market. This entity allows for investors to come and go without disruption of the entity or its affairs. A closed-corporation allows for a smaller management form and allows the majority shareholders/owners the ability to select who will be allowed to invest.

Corporations, as a whole, require significant formalities to form and to continue the business. To form the business, the requirements include incorporation and forming a board of directors. The first major item of business is to fill in and file the articles of incorporation. This process includes providing the name and entity designation (Inc.,

Corp, etc), names and addresses of all incorporators, initial board of directors, and the registered agent for service of process, a stated business purpose (can be general or specific), and a mention of the authorized, issued and outstanding shares as well as a par value, should you set one. This will then be filed and a charter will be provided. The initial meeting will then be held and the entity will be an up and running business.

So, as you see, corporations are an extensive process.

Advantages: Limited liability, flexible capital structure, well-known business type, centralized management

Disadvantages: Extensive initial formalities and filings, double taxation.

) ✓

### 3. Memorialization of provisions

There are several agreements the three of you have made that are areas to be addressed.

#### DD investment of \$100,000 for 25% interest

First of all is the investment to be made by DD. By making an investment into the company of \$100,000 it is important to consider what kind of stock you will be issuing to him, especially if you consider a public company. There are several options for stock but two common forms are common and preferred. Common stock allows shareholders to vote on corporate matters, potentially allows for a higher return on investment but the payment of their interest is significantly subordinated to that of other shareholders. Preferred stock, on the other hand, does not provide for a vote and is usually set to a certain return on the investment but it is paid before common stock. It would also be

✓



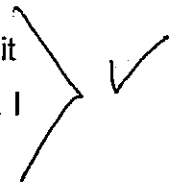
important to consider whether DD stock would be preemptive since he is contributing \$100,000 for 25% interest. His concerns would be dilution of stock.

DD property: In a partnership, property used is an asset of the partnership. Therefore, it is important that the lease paperwork be signed for the rental space at the Raceway. Also, of similar significance, is that when the lease is signed it should be signed by Arthur, Bob and Christina, and, if possible, under the entity name. This is important because any contracts signed by an individual renders them liable as a promoter situation and exposes them to personal liability for any default on the contract. Promoter contracts are agreements between individuals and those forming the business to assist in the organization and start up. Even if the contract is adopted, a promoter is liable on the contract until a novation occurs or they include a provision in the contract stating such.

Christina's checks: Similar to the above, Christina was acting as a promoter when she signed checks for the first two months rent of the office space. By signing the checks, she became a promoter for the not-yet-formed business and can be liable for any default: It is vital that an adoption and novation occur as soon as possible if the checks were taken as an agreement to lease the space. Additionally, it should be memorialized that her personal funds went into the business and is to either be repaid, or is a contribution to the business as a loan. If the check is a loan to be repaid, forms should be drawn and amount should be treated as a conventional loan with a repayment schedule, set interest, etc, so that in the event of a default or dissolution of the entity, her claim does not get subordinated to that of other creditors.

Christina's contract work: Upon forming a business entity with Arthur and Bob, Christina will owe a fiduciary duty of loyalty and possibly care. These duties include, as mentioned above, a duty to not compete, not act adverse to the business, not deprive a

material benefit, act in the company's best interests and not take any opportunities pertaining to the company. While the contract work for FAST is for racecar manufacturers, and the current entity is a emissions control regulator, there are possible concerns to be discussed regarding competition. Being in the same industry, it is easy to see that there can be a conflict between her other work and this opportunity. I would advise consideration into this situation for possible conflicts.



4. Liability for DD's Actions: Typically, a business is vicariously liable for any and all acts performed by an agent of the company when the acts are within the scope of employment or the negligent carrying out of business tasks. An agency relationship is a consensual fiduciary relationships whereby agents agree to act for an under the principal. Agents owe the same fiduciary duty of loyalty as stated above. When DD was performing the test drive, it is questionable whether this was in the scope of his employment. Either way, performing a test drive may have been a performance of a business function. During this time, SECR's could have been found jointly and severally liable if the agent was negligent, careless or acting under actual or apparent authority. However, when DD decided to take the care out for a non-business purpose, the liability of the company ended and he can be found personally liable (Papa Johns).



✓  
good

=====  
End of Answer #1  
=====

2)

=====  
Start of Answer #2 (603 words)  
=====

**Part II:**

1. True



2. True



3. False



4. True



5. True

6. Limited Liability is a term used to describe the protection of liability stemming from the entity's debts for some or all directors, officers and shareholders. If suit is brought against a limited liability entity, the shareholders, directors and officers will only be held liable to their initial investment. There are several entities such as limited liability companies (LLCs), limited liability partnerships (LLPs), and corporations that inherently hold this form. Limited partnerships are partially limited as they do not shield the general partner but offer protection for the limited partners, who act more like passive investors than partners.



7. Piercing the Corporate Veil (PCV): A term used to describe situations where the courts will opt to break the shield of liability of officers, directors and shareholders, this mechanism is offered under certain circumstances warranting further liability. When the PCV occurs, officers, directors and, occasionally, shareholders will be held liable for



the debts and obligations of the entity. Some factors the court will take into consideration in making such a decision would be whether the entity was undercapitalized where there was not enough funds injected into the outset of formation. They will also look to a disregard for corporate formalities (not holding meetings, etc), lack of adequate records (i.e. no minutes from meetings), using the corporation as an alter-ego, satisfying personal obligations from corporate funds, using the corporation for a fraudulent purpose and any fraud, misrepresentation or illegality by officers or directors,

8. A limited partnership is one form of partnership that offers limited liability to some of the partners but not all. In this entity, there is a general partner who acts in a management role and there are limited partners that act more like passive investors. The general partner maintains unlimited liability for corporations and obligations but can mitigate the harm of this role by procuring insurance should there be any suit. Limited partners have limited liability for the entities obligations unless they start to take an active role in management at which time they will lose their liability shield. A limited liability partnership is a form in which all partners manage the entity and maintain their limited liability shield. Additionally, limited partnerships follow the limited partners statutes for filing and LLPs require annual filing to the secretary of state, designating the entity as an LLP, pay a franchise fee and remain in good standing to maintain their status.

9. A partnership requires an agreement arise between two or more individuals who wish to form a business for a profit. This agreement can be express or implied. In the Holmes case, it was held that the discussions between holmes and lerner discussing the skills of one and the money of the other as well as picking a name demonstrated the intent to form a partnership. There are no filing formalities required to get this business entity going.

10. The business judgment rule (BJR) states that absent fraud, illegality or self-dealing courts will not disrupt business judgment. This rule looks to the duty of care in that it ensures people in a business do all that a prudent person would do with their own business. In the case of United the court looked to the lack of a business judgment as a showing that the BJR would not apply holding that a judgment must be made in order to apply BJR. The burden in on the plaintiff to show why the rule should not be applied and is often difficult to prove.

✓  
presumption  
that good  
bus-jmt.  
used.

=====  
End of Answer #2  
=====

**END OF EXAM**