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===== Start of Answer #1 (1324 words) =====

1) Limited Liability:

A term used in business forms that limits the responsibility of the owners personal assets. If the business form has limited liability creditors will not be able to reach the personal assets of the business owners to satisfy the debts and obligations of the business.

2) What is an Exculpation Statute and why did some states enact them?

An Exculpation Statute allows for corporations and other forms of business to limit or excuse the personal liability of directors for decisions they have made in running the business.

States began enacting Exculpation Statutes after a decision in (Van Gorkin) regarding the Business Judgement Rule. The Business Judgement rule requires that Directors make decisions after being reasonably informed of the issues, in good faith that they are doing best for the company, and in a legal manner. Further more in the absence of fraud, illegality or self dealing, the courts will not fault the decisions of the corporation.

In Van Gorkin, a value for the shares was determined by one individual at \$55 dollars. This amount was presented to the Board of Directors who based on the presentation approved the price. They subsequently re evaluated their decision two more times and still approved it. A share holder brought suit that the board had breached their duty of care to act in a prudent manner as well as their duty of

loyalty to act in the best interest of the corporation.

The lower court found for the board of directors saying that they are protected by the BJR. On Appeal the higher court reversed and said that these are a group of highly educated scholars and successful business people and are therefore liable for the decision. Based on their ability this is an obvious ill-advised negligent decision and they should be liable.

This caused a fall out for corporate directors. They were resigning, or scared to make business choices for fear of facing liability. To address the issue Virginia and Delaware made statutory changes in which:

- 1) The Corporation could amend their bylaws or articles of incorporation
- 2) They could lower or eliminate liability for directors.

ALI Standard was also changed in that they lowered the Standard of Care owed by Directors.

### 3) Piercing the Corporate Veil

This doctrine allows for courts to get around the limited liability of companies in rare circumstances and pierce the hypothetical shield between a business owner's personal assets and the debts and obligations of the business. This usually only happens in closely held corporations.

1) **Fraud.** If a business owner/ shareholder is conducting business in fraudulent manner to conceal or deceive creditors.

2) **Undercapitalization:** When funds of the corporation are purposely funneled away from the corporation and sent to shareholders.

**3) Alter Ego.** When the Owner and Corporation are indistinguishable by:

- a) Using corporate funds to pay personal debts
- b) Failing to follow required corporate formalities
- c) failing to keep corporate minutes

**4) Enterprise liability:** When there is a series of small enterprises that are all separate, as in the taxi cab hypo, the corporate shield of enterprise two can be pierced to satisfy number one, and three can then be pierced and so on until the obligation is satisfied.

**5) Deep Rocks Doctrine:** When a business owner is taking out lines of credit or loans against the credit of the corporation for the benefit of the owner and in bad faith, the creditor may be able to pierce the veil and satisfy the debt with the personal assets of the owner.

#### **4) What is needed to form a Partnership.**

Partnerships are formed when two or more join to create a business entity for profit. No statutory formalities are required, however a partnership agreement is highly recommended.

#### **5) Is there a Valuation formula that is appropriate for all businesses.**

No, there is not a valuation formula that is appropriate for all businesses. Different business forms allow for different values. One key issue is whether the business is Private or public. A Public business has a ready market that will allow the business value to be determined on an open market. Private businesses do not have a ready market and therefore their value must be determined by appraisal.

and by financial success. Also different business types are funded and capitalized at different rates. Public corporations can sell stock on an open market, the value of which may go up and down. Private businesses are more limited in capitalizing.

**6) Discuss the complexity in the evaluation of shares in a closely held corporation.**

The difficulty in valuing shares in a closely held corporation is that there is not a ready market to compare a similar size entity against.

To determine the price you could

- 1) sell the them
- 2) get an expert to determine the value
- 3) get a book value
- 4) have them appraised by an appraiser
- 5) ask a similar business if their value has been determined

**7) What is statutorily required in Articles of incorporation?**

- \_\_\_\_\_ 1) The name of the Corporation including the label. (i.e. corp, inc.)
- 2) The company purpose. This is typically stated in a broad manner " to conduct lawful business". However it could be a more specific purpose if desired.
- 3) The number and type of shares the company is authorized to distribute
- 4) Name and addresses of the Incorporators
- 5) Name and address of the original Board of Directors
- 6) Name and address of agent and location for service of process

### 8) Pre-Incorporation agreement:

A Pre incorporation agreement is wise choice for Promoters to create. When an idea of a business entity is being formed a pre incorporation agreement can assist in mentally locking people in to the idea that the business is actually going to be formed. The reason why they are so useful is that Promoters at the pre-incorporation stage are trying to sure up buildings, equipment, and capital. They may be entering into contractual agreements with banks and investors as well as leases and lines of credit. The Pre incorp agreement brings people to the table and binds them to the ideas.

The Agreement should include:

- 1) What the contributions of the owners/shareholders will be in the form of capital, equipment, land ect
- 2) What the Duties and liabilities of the owners will be.
- 3) What will be contained in the bylaws and articles or other controlling documents.

### 9) Internal Affairs Doctrine:

The Internal affairs Doctrine came in to play in a case in which the corporation was incorporated in Delaware but was conducting business in California.. The dispute was whether the laws of CA or Del will control the dispute. The rule establishes that the "Internal affairs" of the corporation such as stock issue, bylaws, and policy issues, are to be conducted in the state of incorporation, Delaware in this case. However, the external affairs of the corporation are governed by the laws of the state that external affairs were conducted in. The purpose of the doctrine was to bring predictability to the laws and which state law controlled.

### 10) Liabilities of Promoters contracts.

A Promoter is a person or entity that has the entrepreneurial spirit in forming a business. In the Pre incorporation stage, the Promoters will enter into contracts with suppliers, manufacturers, banks, and building owners to make sure that when the charter is approved and the organizational meeting takes place, the business entity can begin. The Promoter is completely liable for all the contracts at the pre incorporation stage.

At the organizational meeting the shareholders will look at the Promoters contracts and obligations. IF the corporation approves of the contracts they can ratify the obligations looking back, and adopt the obligations looking forward. Once the Corporation adopts the contracts the corporation and the Promoter are liable under the contract. In order for the Promoter to be released of liability he must seek and receive a novation between himself, the corporation and the thirdparty enterprises.

2)

===== Start of Answer #2 (2716 words) =====

To: A,B,C

From: Me

Date: December 15, 2015

RE: PetPeeves Business

Thank you for your questions and interests. You three seem to have a solid business plan and you're headed in the right direction. I would like to say that it would be a good idea for us to get together and sketch out what everyone's responsibilities would be for this business, no matter which one is chosen. Currently it looks like A holds an initial patent, C does marketing and website support, and SM is contributing money. I'm unclear about what B is doing for you guys and it may be very helpful to you all to discuss everyone's rolls before this starts to heat up with things to do.

That being said, there are concerns which need to be addressed here:

**SM's Personal Lawyer:**

I understand that SM has offered to put you three in contact with his personal lawyer in order to draw up the business plans. There is a conflict of interests here, as he currently represents SM as an individual, and he would be advising your company's formation

now. Though this could potentially be waived currently under 3-300, it would have to be done so in writing and in the future could cause considerable headaches. This is because as you will learn later in this letter, there are a variety of ways in which you can set up this business. Some of the potential ways will expose SM to more liability than others, along with you three as well. This means in the long run, SM's personal lawyer, has a conflict of attempting to protect SM's interests potentially more than your interests. I am not saying he will, but it would be advisable for you to retain at least an independent lawyer for you three to draw up the paperwork. As luck would have it, I am extremely well versed in business organizations and can advise you on a variety of subjects. I would love to take responsibility for drafting up your business after we establish what exactly you're looking for.

red!  
stop!

nice

**First, lets talk about the various entities you could form together:**

**Sole Proprietorship:**

The first business entity is known as a sole proprietorship, and may only be established by an individual or married company. As this does not apply to you, we will move to the next one.

**Partnerships:**

Partnerships come in three major types and they all have their particular nuances which will be addressed. The tax issues related to all partnerships are the same: the profits of the company "pass through" to the partners, and the profits are taxed at that level. This is advantageous over a corporation as you do not get double taxed, and is certainly something to think about.

The first type of partnership a general partnership. A general partnership exists when one or more individuals implicitly or expressly agree to form a business in order to make



money. Technically you three have formed a partnership, but I would caution you to it will be advantageous to actually form a different entity to protect your interests.

Next, there is what's known as a Limited Partnership. In a limited partnership, there are two kinds of partners: general and limited. The general partner is completely responsible professionally and personally for any debts of the partnership. However, the limited partner is treated like a silent investor and is only liable to the partnership for whatever he puts into the business. Here, A, B, and C could potentially be general partners, with SM being a limited partner. This is a potential option and would allow you to maintain closely held managerial control. However, it does put you three as being jointly and severally personally liable for any debts of the partnership.

The third potential partnership option is what is known as a Limited Liability Partnership ("LLP"). Though the LLP has not been around as long as Corporations, it is a fast up and coming business entity because it offers great flexibility. A LLP allows for individuals to get pass through taxation of profits, which gaining limited liability, which allows for them to shield personal assets from potential partnership liability. Although this sounds perfect for your business, currently LLP's are only offered to professional groups such as lawyers, accountants and doctors. But, other business organizations can provide the same protections, as I'll explain next.

### **LLC's and Corporations:**

Moving past Partnerships, in an effort to limit your personal liability and tax consequences, we have to last options: Limited Liability Companies and Corporations.

### **LLCs**

LLC's are a very flexible business type and are very similar to Corporations. They do require a great deal of money and energy to start up, documents must be filed with the

Secretary of State and though it does not need to be filed with the Secretary of State, we will need to draft a Operating Agreement. In an LLC, the operating agreement is very important and details what the LLC will do, how it will work, where it will get money, and how money will be paid out. These are very important principles which we must write down so that everyone is on the same page. However, in return for the above mentioned formalities, you would receive limited liability. That means that you three, A, B, C, would owe nothing on the LLC's debts. This is because you put nothing in personally. Obviously you would need to allow the LLC to keep some of its earnings internal so that it could continue to operate, but your personal assets would be safe. SM would be in a similar boat, however, he would be liable for the \$50,000.00 he had invested, but no more.

The liability shield here would obviously protect you, and LLC's also provide another large benefit: in both management style and taxation, they allow you to choose what works best for you. Corporations generally are centrally managed do not allow flexibility for closely held management, though it can be accomplished. LLC's expressly allow you to manage the LLC as if it was a partnership This would allow A,B, and C, to run the partnership together and allow SM to maintain a limited role if he wished. Secondly, the LLC would allow for pass through taxation This is because states allow the partnership to choose if it wants to be taxed as a corporation or as a partnership. Now, I am not saying that you will always want to be taxed as a partnership, but especially early on when you're likely to not be making too much, it will be a huge advantage not to be double taxed.

### **Corporations:**

Lastly, we have a traditional Corporation as an option. The Corporation is a well established entity which allows for limited liability protection essentially in return for some formal requirements and double taxation. A Corporation is established by filing an Articles of Incorporation with the Secretary of State. This includes a variety of general information, including the name (Hopefully PetPeeves is available), who is on the board

of directors, who the incorporator and agent for service of process is, how many shares and of what time are being issued, a short statement of purpose, as well as additional items. This likely sounds like some work to put together, and it is. There is a start up cost, and after the actual incorporation, you have to establish by-laws, have shareholder meetings at least annually, record the meetings with minutes, establish officers to run the corporation, etc. Again though, in return for this effort, you are rewarded with Limited liability, which for you four (A,B,C, SM) is going to be very important.

Management style in corporations can be unweildly and its unclear if that is what you would want here. You could issue 1/4 shares to A, B, C, and SM, and then you would all have 1/4 share of the corporation. Some things to think about would be as follows: do you want SM to be part of the management of have control of the company? If not, you could potentially issue him a Type B stock which had no voting rights. He would likely want something in return for this, and you could satisfy that will some sort of preferencial buy out for him, either as to price or time. That just means that he could get a better price for his stock, or he could get a buy out sooner than you three. That is if he would require a sweetner to exchange his voting rights. He may not be interested in the day to day, which would work for now, but potentially in the future he may want to vote, so its something you three, A,B, and C, the people with the vision, should think about.

Lastly, Corporations get double taxed. That means when the corporation declares a profit, its taxed. Then on your individuals income tax, you'll be taxed again. There are ways to limit the tax consequences here, and we may be able to establish salaries for the Board of Directors or reinvest the earnings to limit the on paper profits the corporation will incur. There is also the possibility of incorporating overseas as some point in the distant future: maybe we establish your corporate headquarters in Ireland to take advantage of the 10% corporate taxation (in the USA it is 34%) and leave a substantial part of your overseas earnings outside the reach of the US government. Thats something to think about though when you get really really large and successful.

Remember me helping you get started when you get to that point.

**Other Concerns:**

I have some other concerns and provisions which, no matter what entity you choose should be considered. I would advise that you decide on an LLC or a Corporation, with myself leaning towards an LLC for you. This is because I believe it would shield you personally while allowing you to pay the least amount in taxes. A natural win / win. Though there is a substantial amount of formalities which an LLC must comply with, including annual payments for this status, in the long run, you'll be glad you invested in it.

**C As Promoter:**

Secondly, C has become what is known as a promoters. A promoter is an individual who pays money out of pocket on behalf of a business entity that has yet to be formed. Here, he has rented out the space we need, using his personal funds. He is currently personally liable if something should go wrong. I would suggest that no matter what entity is formed, this is the first priority that needs to be dealt with. We need to memorialize a payment back to C, or loan documents to C, or allow C for additional equity in the business based upon his contribution. The best solution would likely be to pay C back if you can afford it, if not, establish loan documents, paying the standard interest rate. The interest rate will be tax deductible, so that will also help a small amount. If you do establish a corporation, you will want to have the board of directors take up this issue at their first meeting and adopt or ratify C's conduct on behalf of the Corporation. That will protect everyone here.

**Internal Affairs**

Next, A, B, C, and presumably SM are from different areas of the country, so something

*Good!  
Always  
speak  
up!!*

✓

*good*

to think about if you choose a corporation is where to incorporate. Many people choose Delaware because it has a friendly court system for corporations and a low tax rate. If you choose to incorporate, this is something to consider, but it may cost additional money in order to pay someone in Delaware to go through the effort for such a small incorporation that it may not be worth it.

If you choose to form an LLC, as I recommended, you will need to be wary of what law applies to the governing of your LLC. You are planning to produce your products in Sonoma County, and as such, you'll be filing the LLC with the state of California. However, you could put in your operating agreement that another state's laws apply to the internal affairs of your LLC. In LLCs you can determine what you want to happen and have great flexibility in order to accomplish your goals. California does have very strong protections from LLC's and in the realm of when to pierce the corporate veil has good case law you can take advantage of, so I see no need to establish another state's laws as governing your LLC.

### C's Job with Pet Smart

One thing that worries me is C retaining his national part-time marketing job with Pet Smart. I am currently unaware of what Pet Smart does, but it may be a conflict of interest for C to work for both them and Pet Peeves. There are two potential solutions. First, we could write in the LLC operating agreement that there is no duty not to compete (Anderson). Generally, individuals within an LLC do owe each other some duties of loyalty and other fiduciary duties. Here though we could expressly allow for it to occur. There is an issue with this solution, and it is that C is an agent of Pet Smart, and we would be running the risk of Pet Smart suing for his breach of fiduciary relationship to them. This is because generally you want fidelity of agent. Typically the agent owes the principal a duty not to compete, not to use the principal's information to help a 3rd party, and not to disseminate information to a third party. Though A, B, and SM, are not liable to Pet Smart, if C runs afoul of them (like if they find out he is starting a competing business), the LLC could be liable to Pet Smart. So, the second options

arises and is advised: C should quit his job with Pet Smart if he wishes to work with PetPeeve. If C wishes to retain his position with PetSmart, it is likely more advantageous to A, B, and SM to find another marketing person rather than stir up that hornets nest.

I was also just reminded that C acted as a promoter for us, and I advised to adopt his conduct on behalf of the company. We need to think through that completely given his relationship with Pet Smart and figure out our exact position before we take on that liability. If C is going to remain with Pet Smart, it may be more advantageous to keep him as a creditor for the rent payment and hold him out at arms length. But this issue will require further thought.

*always good*

### 2015 Cat Amputation:

The answer to your liability based on the cat amputation depends upon the business entity when you decided to establish after our initial consultation and what has happened since. If you remained in a general partnership and drew up nothing further, you may be in trouble personally. I say that because in a general partnership you can as individuals be liable for the debts of the partnership. If you chose to establish a limited partnership with A,B,C as General Partners and SM as a limited partner, SM would be limited to 50,000 and A,B,C would all be not protected as far as their individual assets goes.

If you chose to establish an LLC or a corporation, you will have personal liability shielding, as long as you've kept up with the formatilys and have not done anything to allow the cat's owner to pierce the corporate veil.

The good news here, no matter what you've done, the amount at issue here cannot be overally substantial. A cat amputation generally only awards the actual vet bills incurred and potentially the emotional distress of the "owners". I would hope that the company

would be in a position to pay this off. If funds are tight, I would recommend that you see what you have available in whatever entity you have established, and attempt to settle with the family. If the family wont settle and the alleged amount they want is grossly excessive, I can recommend many very established defense attorneys would be gladly prosecute this case for you.

✓  
Nice.

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===== End of Answer #2 =====  
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**END OF EXAM**