Excepts from PROF. RegANIS
PAST BUS. ORGS. EXAMS

QUESTION TWO

The government agency responsible for managing the federal courthouse building in Philadelphia publishes a notice that the government is soliciting bids from parties interested in an opportunity to contract with the government to manage the building's cafeteria. The winning bidder will be given the exclusive right, for a five-year term, to manage and operate a cafeteria-style restaurant on the second floor of the 20 story building.

Daniel reads the notice and contacts Kirby, an old acquaintance of Daniel's (from the days when they worked together as purchase managers for Marriot Foods), to explore Kirby's interest in joining with Daniel in bidding for the cafeteria contract with the federal government. Kirby enthusiastically accepts Daniel's offer to form a "50-50" partnership with him for this purpose (known as "Daniel and Kirby") and, to the delight of the would-be entrepreneurs, they win the contract with the federal government.

In agreeing to bid for the cafeteria contract, Daniel and Kirby do nothing more than submit a written proposal to the government in conformity with the federal agency's bidding guidelines. As between themselves, they simply shake hands and orally agree to be partners in the cafeteria business. Upon winning the contract, Daniel and Kirby each contribute \$50,000 to the partnership to get started.

Please answer all the following sub-parts of this question 2 with reference to the appropriate provisions of the Uniform Partnership Act [Code Book at p. 603 et seq.] on the assumption that "Daniel and Kirby" is a Pennsylvania partnership.

- (a). Contrary to Daniel's explicit instructions, Kirby orders \$5,500 worth of computer equipment for the business from Compu-Line, Inc. ("CLI"). Daniel refuses to accept delivery and CLI sues everybody in sight for breach of contract. Is the partnership liable on the contract with CLI? Are Daniel and/or Kirby personally liable on this contract? Explain your answer.
- (b). Assume three years have passed since Daniel and Kirby began to operate in the federal building. Although the partnership, as expected, has been profitable every year, Kirby has lost much of his original enthusiasm for the venture. He is understandably pleased about the financial success of the business, but he is increasingly troubled by the cost of this success in

personal terms. Daniel and Kirby have both worked extremely long hours ever since the business opened and there seems to be no light at the end of this tunnel. Kirby consults you about the partnership and expresses his desire to inform Daniel first thing tomorrow morning that he "wants out." What advice do you give Kirby about his rights and liabilities in this regard?

(c). Kirby appreciatively receives your sage advice (in response to sub-part (b) above) and he resolves to make a decision in the next two days about his continued involvement with the partnership. He never gets the chance to decide, however, because he dies in a car accident later that very day. Kirby's widow, later seeks your advice regarding her rights in relation to Kirby's interest in the partnership. Amy informs you that Daniel wants to continue the business solo. Daniel telephoned Amy last week and offered to settle the affairs of the partnership by returning Kirby's original \$50,000 investment to Amy, with interest, under a three year payment plan. Amy is upset because, among other reasons, Kirby told her two months ago that he thought the partnership, as a going concern, was worth at least 3 times its overall original book value of \$100,000. Moreover, Amy does not want to wait 3 years for the money; she wants an immediate pay-off in full and at a fair price. What do you advise Amy about her rights in this matter?

OUESTION THREE

Harry and Sally both own 100 shares or 50% of the 200 outstanding shares of common stock of Best Lawn Enterprises, Inc. ("BLE"), a corporation doing business in, and organized under the laws of, State Red. BLE sells and services small tractors, lawn mowers and other lawn care products to residential customers. As part of its customer-friendly business plan, BLE has two trucks that it uses to pick up and deliver to customers' homes the various kinds of equipment that BLE sells and services.

From the inception of the business 5 years ago, Harry and Sally have continued to be the only shareholders and officers of the company. Nominally there are three directors on BLE's board, but only Harry and Sally have attended the handful of board meetings that have been held over the years. Harry and Sally regard this third director -- their friend Morty -- as simply a figurehead whose only perceived role is to break any deadlock that might arise at board level between Harry and Sally. Fortunately, Harry and Sally have always agreed on important business decisions and thus have never called upon Morty to vote on any business matter.

Harry and Sally initially formed BLE with a combined equity investment of \$100,000. Specifically, Harry paid the corporation \$50,000 in cash for 100 shares of common stock (i.e., \$500 per share) with a nominal par value of \$1.00 per share. Sally did likewise. Harry also loaned the corporation an additional \$100,000 over and above his \$50,000 equity investment. Again, Sally did likewise. No promissory notes were signed by the corporation with regard to these two loans nor were any specific repayment terms established. The corporation's financial statements did, however, contain a line item on the "Liabilities" side of the balance sheet that read:

"Loans from Shareholders.....\$200,000".

BLE thus commenced operations with a total of \$300,000 on hand (\$100,000 in equity and \$200,000 borrowed from its shareholders).

The business struggled from the outset. Revenues barely covered expenses, forcing Harry and Sally to work long hours for no salary. In year 3, revenues held steady but expenses soared. To keep things afloat, Harry and Sally decided to let the corporation's products liability insurance policy (affording coverage limits of \$2 million per accident) lapse. As Sally would later explain, "the exorbitant annual premiums -- almost \$50,000

per year -- were killing this business. Products liability insurance became a luxury we simply could not afford." As yet another cost-savings measure, Harry and Sally considered canceling the motor vehicle liability insurance coverage on the two trucks, but they quickly abandoned this idea when they learned that the law of State Red made such coverage mandatory.

With no opportunity to draw a salary, Harry and Sally caused the corporation to make substantial distributions to themselves over the years in the form of (i) partial repayments on the loans from shareholders and (ii) distributions of paid-insurplus (thanks to the nominal par value selected for the common stock). At the end of year 4, the two shareholders' combined equity investment stood at \$20,000 (down from the initial \$100,000) and the balance due on the loans from shareholders was \$100,000 (down from the initial \$200,000 balance on both loans). In year 5, Harry and Sally also caused the corporation to borrow \$85,000 from Friendly Savings & Loan ("FS&L"). To the shareholders' surprise, FS&L did not request any personal guarantees for the loan. That same year, Harry and Sally also persuaded Sally's cousin Vinny to "loan the business" \$20,000 by making verbal assurances to Vinny that they would "personally stand behind" the loan if the business should fail.

Year 5 ends with a terrible accident. One of BLE's customers, Victim, is severely burned when a recently serviced tractor-mower explodes the first time Victim attempts to use it following its delivery to Victim's home by Harry. Victim loses a leg as a result of the blast and is otherwise completely and permanently disabled by severe burns over 80% of his body. Distraught, Harry and Sally decide to close down the business. They resolve, however, to maintain the corporation's existence until all outstanding claims are resolved. As year 5 comes to an end, Harry and Sally cause the corporation to pay them the entire \$100;000 outstanding balance on the loans from shareholders. As a result of these loan repayments, the corporation now has only \$20,000 on hand, against which liens have been attached by the government of State Red for various unpaid taxes.

- (a). You represent Victim. Make your best case for holding Harry and Sally personally liable on your client's personal injury claim. In your answer, please (i) identify the pertinent legal factors underlying your theory or theories for holding Harry and Sally personally liable to Victim and (ii) apply these factors as forcefully and responsibly as the given facts permit.
- (b). Assume FS&L sues Harry and Sally personally on the \$85,000 loan to BLE. As law clerk for the judge who will hear this claim, please prepare a short memorandum in which you briefly set forth the arguments for and against imposing personal liability on Harry and Sally for the FS&L loan. Consistent with Her Honor's

expectations, your memo should include your reasoned recommendation as to how the court should rule on this claim by FS&L.

(c). Assume you represent Vinny in a lawsuit to recover his \$20,000 loan from Harry and Sally personally. One setback is that the court just ruled that any direct claim by Vinny on the oral promise of Harry and Sally -- to "stand behind" the loan -- is barred by the Statute of Frauds. Is there nevertheless some way you can use this evidence to press Vinny's claim against Harry and Sally personally? In all events, how do you respond to your client's request for an objective assessment of his chances of prevailing against Harry and Sally personally? In responding, please explain to your client the reasons underlying your opinion in this regard.

OUTLINE OF SAMPLE ANSWERS TO OLD EXAM QUESTIONS

QUESTION TWO

2(a). [authority re purchase of computers from CLI]

- * Partnership <u>is</u> liable. <u>UPA Sec. 18(e)</u> gives Kirby actual authority and no indication of contrary agreement requiring unanimous approval of purchases (intro language of UPA 18).
- -- <u>UPA Sec. 9(1)</u> acknowledges actual authority in each partner to bind partnership (as well as apparent authority in appropriate case). This is case of actual authority, however. Daniel's "explicit instructions" do not deprive Kirby of his actual authority because <u>UPA 18(e)</u> equal-management default rule applies.
 - * Daniel and Kirby both personally liable to CLI.
- -- UPA 15(d) makes plain that all partners are jointly liable for the debts and obligations of the partnership.

2(b). [power to dissolve/at will v. definite term]

- <u>UPA Sec. 31</u> gives Kirby the <u>power/right</u> to dissolve the partnership at any time. No such thing as indissoluble partnership BUT Kirby may be liable in damages for breach of agreement, albeit implied, for a partnership for a definite term of 5 years given formation of partnership for express purpose of bidding for government contract under circumstances in which was clear that fed agency was looking for 5 year commitment. <u>UPA 31(1)(a),(b).</u>
- -- <u>UPA 31(2)</u>. If Kirby's unilateral act to dissolve is in breach (there are 2 years left on the 5 year commitment) he is personally liable to Daniel for damages.
- -- <u>UPA 31(2)(a)II</u> expressly provides for damages upon one partner's wrongful dissolution
- -- UPA 38(2)(b) allows non-breaching party right to continue business
- -- Kirby may also be personally liable to the government under the partnership's contract with fed agency (UPA 15(d)) if Kirby's withdrawal puts partnership in breach of its contract with fed agency
 - -- Advice. Given significant risk of personal liability

for damages if breach, recommend negotiated withdrawal wit. financial settlement and mutual releases. If cannot achieve acceptable negotiated solution, be wary of unilateral dissolution on these facts. Liability for breach would appear more likely than not. Business risk in this regard is for client to make.

If Kirby does decide to dissolve, be sure to advertize fact of dissolution to cut off liability under UPA 35(1)(b)II.

2(c). [advice to Amy re widow's rights in p'ship]

- * Amy's rights/options re dissolution. Amy, of course, is in Mrs. Cauble's shoes. Daniel and Kirby shook hands (i.e. no "otherwise agreed" contract in place).
- * $\underline{\text{UPA 31}(4)}$: Kirby's death triggers dissolution BUT, under $\underline{\text{UPA 30}}$, dissolution does $\underline{\text{not}}$ equal $\underline{\text{termination}}$ of partnership unless a "winding up" occurs.
- *<u>UPA 21(b)</u>: Daniel accountable to Amy as a fiduciary ("This section applies also to the representative of a deceased partner...")
- * <u>Liquidation option. UPA 38(1)</u> empowers Amy to force a liquidation of the partnership to realized immediate value now ["have partnership property applied to discharge its liabilities and the surplus applied to pay in cash the net amount owing to ... partners."]
- -- practical problem is possible loss of going concern value in the business by forcing liquidation and realizing only break-up or book value.
 - -- can use liquidation option as bargaining chip.

* <u>UPA 42 Ascertain Value of Interest</u>

-- Amy can waive UPA 38 liquidation rights and have value of Kirby's interest in partnership ascertained under <u>UPA 42</u>. Cauble case suggests she has room in this setting to argue for the greater going concern value of Kirby's interest (a fair outcome because that greater value from winning the state contract is attributable in significant part to Kirby's role in the partnership).

- -- Ordinary creditor status. Daniel has no right under UPA 42 to insist on a 3 year payment plan. Amy, once the value is ascertained (as of date of death), becomes entitled to payment as ordinary creditor. She could play hardball and levy on the assets of the partnership to satisfy her judgment (subject to rights of other creditors) although this may be self-defeating if the added value is not realizable in break-up/forced sale of assets of business.
- -- <u>Further UPA 42 election.</u> Amy also gets to choose between interest on the value or Kirby's share of profits in business during period in which (and arguably to extent to which) value of Kirby's interest remains unpaid.
- * $\underline{\text{Advice.}}$ Amy's best move is to negotiate for the higher value under UPA 42 (or litigate for it, failing agreement with Daniel) and live with a 3 year payment plan that gives Amy the greater of profits or some stated rate of interest.

QUESTION THREE

- 3(a). [Victim's personal injury claim against Harry and Sally personally]
- * Tort. Best claim is to sue Harry and Sally directly as tortfeasors, i.e. the actors who personally participated in the events leading to the accident. [E.g., a negligence claim based on failure by H&S to service and/or inspect equipment properly, etc.]
- -- MBCA 6.22 provides limited liability protection to shareholders <u>except</u> that shareholders "may become personally liable by reason of [their] own acts or conduct."
- * Pierce corporate veil. Second-best route is to argue for disregard of corporate entity such that brothers can be held personally liable for debts and obligations of corporation. Argue that permitting corporate form to shield H&S from personal liability to Victim on these facts would produce unjust and inequitable result and extend principle of incorporation beyond its legitimate purposes.

* Pertinent factors:

- -- Proof of plain fraud not necessary
- -- Obvious inadequacy of capital given nature of H&S' undertaking and substantial personal risks involved in business. Initial capital systematically depleted and products liability insurance "asset" eliminated unreasonably in light of business risks. Whether initial capital was sufficient should be deemed irrelevant given H&S' systematic stripping (siphoning of assets) of corporation of its financial viability and of its ability to meet significant business risks that foreseeably may have been encountered with lawn mower equipment.
- -- Failure to follow formalities/non-functioning of 3rd director. H&S treated the business like a partnership and cannot be heard now to assert that it's really a corporation that shields them from personal liability. Only handful of board meetings and one director, Friend Morty, has never attended or cast a vote. (Yes, Morty is a deadlock breaker but this does not excuse his abdication of director's fiduciary duties. There is no such thing as a figurehead director.)
- -- <u>Close corporation.</u> Only 2 owners, the principals who ran the lawn mower shop.

- -- Siphoned funds/personal manner of operations. The withdrawal of substantial monies (in return of paid-in-capital surplus and "loan" repayments) served H&S' purely personal needs and were likely contrary to the best interests of the corporation. Can articulate corp. as mere agent/instrumentality of H&S. Thus H&S are liable personally as principals for acts of their agent -- the corp., BLE -- within scope of actual and apparent authority like servicing and delivering mower equipment.
- -- Element of injustice/fundamental unfairness. Patently unfair to Victim to find "shell" as only entity available against whom to seek recovery. Nature of business and obvious risks to customers makes decision to cancel products liability insurance inequitable if not unconscionable, particularly since H&S were withdrawing substantial sums from the business. Presumably, some portion of these monies could have been used to maintain appropriate insurance.
- -- Plaintiff Victim an involuntary creditor. Although the Victim was a voluntary customer of the mower shop, any voluntariness in this regard related to contract claims on the service of the mower. As for Victim's tort claim, he should be regarded as any other involuntary creditor. As such, Victim is a compelling plaintiff in weighing equities on pierce question.

3(b). [bench memo re FS&L \$85K loan claim]

Arguments for personal liability to FS&L.

- -- Pierce factors. Same general pierce factors as 3(a) above except liability insurance, a big factor with the tort claim, is a non-factor here except in the most general sense of lack of adequate capital. Thus, lack of adequate capital, lack of corporate formalities, siphoning of monies and depleting wherewithal of business to meet credit obligations point toward possible "pierce" for benefit of FS&L.
- -- Equitable subordination. Argue in alternative for equitable subordination (Deep Rock doctrine) of Loans from Shareholders, and recoup monies paid to shareholders on account of these loans, at least as to amounts paid at end of year 5 (i.e., \$100,000 -- more than enough to satisfy FS&L loan) when H&S knew corporation unable to meet its then existing obligations.

Arguments against pierce re FS&L claim.

-- FS&L is sophisticated, voluntary creditor. It dealt

with corporation on totally voluntary basis and seeks a "windfall" by materially improving its credit risk after-the-fact by attempting to hold H&S personally liable.

Financial statements disclosed "Loans from Shareholders". FS&L on actual notice of precisely the credit risk it undertook and fact that personal loans from shareholders, in the amount of \$200,000, were outstanding. Bank could have protected itself by normal means, such as subordination agreements with H&S in advance and/or personal guarantees.

For these latter reasons, I would recommend disallowing the bank's claims against H&S personally.

3(c). [Vinny's \$20K loan]

Vinny is unsophisticated, albeit voluntary, creditor. Vinny has good chance to win, i.e., more likely to prevail than not against H&S personally.

Oral promise not independently enforceable but <u>Dewitt</u> (at p. 280) is authority to admit such evidence in support of claim to pierce corporate veil. Vinny's reliance on H&S' assurance lends further strength to his claim of injustice/fundamental unfairness.

Same factors as 3(a) support strong pierce claim here (except tort liability insurance factor for reasons given in 3(b) above).

Voluntary creditor status. This cuts against Vinny's chances, perhaps significantly, but should not prevent him from prevailing on the pierce claim. He's family, not FS&L. See text at pp. 282-283, note 3 (where party dealing with corporation is not commercially sophisticated, courts may presume that this party does not normally assume the risk that the corporation is inadequately capitalized.)

Given the close held business (H&S only shareholders), Morty's informal directorship and most compellingly, H&S's personal assurances to Vinny, I believe the "voluntary" creditor status should not defeat Vinny's claim. It complicates his chances, but I believe the H&S' assurances more than offset this factor when the equities of the situation are weighed in toto. Vinny should proceed to trial unless H&S make a substantial settlement offer.