MONTEREY COLLEGE OF LAW

BUSINESS ORGANIZATIONS
Final Examination
Spring 2020
Prof. D. Lamb

INSTRUCTIONS:

There are three (3) questions in this examination. You will be given four (4) hours to complete the examination.

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Mr. A's is a locally famous restaurant in San Diego with a long and storied history as a watering hole for members of the local trial bar. Its menu concentrated on grilled prime steaks and seafood. In the first decades of the 21st Century, however, the trend toward healthier eating, with its focus on plant-based diets and farm-to-table cuisine, began to take its toll on Mr. A's profits.

Seeing the handwriting on the wall, the owners of Mr. A's decided to revise their menu to offer healthier cuisine. They hired local health food guru Kael Ruffidge to scout out organic farms in Southern California and enter into contracts with any growers whose produce impressed Kael. The contract between Mr. A's and Kael provided as follows:

Kael is authorized to enter into contracts with any SoCal grower he chooses, but he cannot commit Mr. A's for more than a six-month contract and a total price of no more than $15,000.

Mr. A's took out a full-page ad in the Sunday edition of the Union Tribune announcing Kael's new role as a consultant. "Kael will be touring farms throughout SoCal and entering into supply contracts with growers that adhere to the high standards that Mr. A's has adopted." The ad did not disclose the terms of Kael's contract.

Purporting to act on behalf of Mr. A's, Kael entered into the following supply contracts:

(1) A three-month supply contract for organic rutabagas from Tipsy Turnips in Encinitas with a price limit of $10,000.

(2) A one-year supply contract for the entire crop of baby vegetables from Chuy's produce in Rancho Santa Fe for "market price".

(3) An agreement with Tyson's food of Salisbury, North Carolina, to supply frozen organic chicken parts for a three-month trial period for a price not to exceed $10,000 and a secret side agreement to employ Kael to endorse Tyson's in a series of television commercials.

The San Diego bar reacted badly to Mr. A's announcement of its new culinary direction. Trial lawyers were horrified at the prospect of sipping their martinis next to Birkenstock shod "hippies", and they quickly found new watering holes to patronize. Alarmed, Mr. A's reversed course and canceled the contracts Kael had committed it to.

Tyson's, Chuy's and Tipsy Turnips all sued Mr. A's in San Diego Superior Court. Is Mr. A's liable on any of the three contracts made by Kael? Explain.

Business Organizations
Final Exam
Professor Daniel Lamb.
Spring 2019

QUESTION 2

CBD, Inc. is a corporation that manufactures Gummy Bears laced with CBD oil. It has only one class of stock, ownership of which is divided as follows: Andrew owns 30%, Billy Bob owns 8%, Chuy owns 7%, Darwin owns 30% and Ezekiel has 25%. Andrew and Billy Bob retired as officers a few years back and have taken no active role in the business since then other than attending the annual meetings and voting their shares. The board of directors is made up of Chuy, Darwin and Ezekiel, and these three, respectively, are now the president, vice-president and secretary of the corporation.

The corporation recently received an offer to buy all of its assets for $15 million in cash. Darwin and Ezekiel were ecstatic about the offer, but Chuy was not because he believed the assets were worth a great deal more, particularly the recipes for the gummy bears that Chuy had personally developed.

The prospective acquirer demanded an answer within 72 hours. Without giving Chuy any advance notice, Darwin and Ezekiel met in the corporate offices and invited Chuy to participate by Zoom call. Chuy was reluctant to do so but agreed and listened as Darwin explained the terms of the offer. Neither Darwin nor Ezekiel mentioned that they would be employed by the acquirer if the deal went through. Despite Chuy's vehement disagreement, the board voted 2-1 in favor of accepting the offer, with Chuy voting an emphatic "no". Ezekiel and Darwin immediately commenced negotiations with the offeror.

The minute Chuy ended the Zoom call, he phoned Andrew and Billy Bob. All three agreed to oppose the deal because they believed the offer grossly undervalued the assets of CBD, Inc. They want to block the sale, or failing that, they want to get what they consider to be a fair price for their shares.

1. What procedural and substantive defects, if any, may Andrew, Billy Bob and Chuy raise as objections to the proposed sale? What kind of lawsuit would they bring? Explain

2. How could Darwin and Ezekiel cure any defects?

3. Assuming Ezekiel and Darwin can force the sale over the objections of Andrew, Billy Bob and Chuy, what are the rights, if any, of Andrew, Billy Bob and Chuy to get a fair price for their shares?

Business Organizations
Final Exam
Professor Daniel Lamb
Spring 2020

Question 3

When Alta, Benoit and Choate learned that their employer, TSquare, Inc. was for sale, they saw an opportunity to conduct a leveraged buy-out and finally be their own bosses. Alta met with the president and sole shareholder of TSquare and offered to acquire all of the assets of the company, sign a lease on TSquare's office building, and take out an insurance policy on the assets. After some negotiation, the two agreed on a price of $250,000 payable in five annual installments and drew up a legally enforceable contract which Alta signed on behalf of "a corporation to be formed later" as the purchaser. Subsequently, Alta, Benoit and Choate duly formed REO, Inc., and Alta assigned the contract with TSquare to the new corporation. REO then assumed Alta's obligations under the TSquare contract.

Alta, Benoit and Choate each invested $2500 for 1/3 of the stock of REO. They elected themselves directors, and then appointed Alta as President and Benoit as Secretary. Unfortunately, their plan to leverage the purchase fell through, because they could not find a lender who would make a loan to them. REO made no payments to TSquare, no insurance was obtained, and several rent payments were missed. TSquare brought suit against REO and against Alta, Benoit and Choate individually, to recover the $250,000 purchase price of the assets. The evidence introduced at trial showed the following:

1. The contract under which REO assumed Alta's obligations to TSquare was signed by Alta as President of REO, by Alta as an individual and by the President of TSquare agreeing to accept REO as the obligor. Benoit certified to TSquare in writing as Secretary of REO that Alta was authorized to sign on behalf of REO.

2. Before the contract with REO was signed, TSquare had requested personal guarantees from the three shareholders, but all three refused.

3. REO had no minute book, and no corporate records were kept.

4. Before TSquare agreed to accept REO as the obligor under the purchase agreement, Benoit showed representatives of TSquare a financial statement indicating that REO had a net worth of $100,000. In fact, it only had $2500 in its bank account.

5. Approximately one year after the deal with TSquare closed, the three shareholders dissolved REO and sold the assets purchased from TSquare to Four Roses, Inc.

Decision? Explain

Question 1 Issues Checklist

Points	
	Tipsy Turnips K
15	Because Kael had actual express authority to enter into this K, Mr. A's is liable
5	An agent has actual authority when he takes action designated or implied in the Agreement of agency.
5	Kael's K with Mr. A's authorized Kael to contract for a supply of organic vegetables that did not exceed 6 mo's and for a total price of less than $15000. The K with Tipsy Turnips was within these limits.
	Chuy's Produce K
10	Mr. A's is liable because Kael had apparent authority to enter into this K.
5	An agent has apparent authority when a third party reasonably believes the agent has authority to act on behalf of the principal.
5	This belief must be traceable to the manifestations of the principal.
5	Kael did not have actual authority to enter this K with Chuy's because the term (1 Year) exceeded the 6 month limitation imposed by Mr. A's and because the total price was not limited to $15,000.
5	But Mr. A's newspaper ad said that Kael would be entering into supply contracts with SoCal growers and did not describe any of the limitations on Kael's authority
5	Based on the newspaper story, Chuy's could reasonably believe that Kael had authority to enter the supply contract because Chuy's was a SoCal grower. Further, market price may be a typical price point for these contracts.
	Tyson's Foods K
10	Mr. A's is not bound by this K because Kael did not have either actual or apparent authority to enter this K.
10	Kael did not have actual authority because his K with Mr. A's was limited to produce contracts. Although agents have the authority to do acts that are incidental and necessary to their actual authority, entering into a contract for frozen chicken parts was not such an act.

Kael did not have apparent authority because Mr. A's had announced that Kael would be contracting with SoCal growers.

Even if Tyson's was not aware of the newspaper ad published in a local newspaper on the other side of the country, it was not reasonable for Tysons to believe that Kael had authority without checking with Mr. A's. Had it done so, it would have learned that the contract exceeded Kael's authority.

Further, as an agent, Kael owed fiduciary duties to Mr. A's that prohibited him from self-dealing or profiting personally from the discharge of his duties. Kael's secret endorsement contract violated this rule, and Tysons' apparent agreement to keep this side deal secret shows that they knew Kael was breaching his duty and therefore outside his authority.

Question 2 Issues Checklist

Points	Issues
	Substantive Defects
10	The sale may constitute an unfair interested director transaction in breach of E and D's duty of loyalty to the corporations because the acquiring corporation is keeping D and E as employees.
5	Even without disclosure, transaction can be upheld if directors prove "entire fairness". If A,B & C prove price was too low, court will not find entire fairness
5	Rebuttable presumption of unfairness where material facts are not disclosed to the board and the shareholders.
5	Appropriate lawsuit for director breach of duty of loyalty is a derivative action on behalf of the corporation.
5	A, B or C have standing to bring derivative lawsuit because all were shareholders when the sale was approved and all continue to be shareholders when lawsuit brought.
	Procedural Defects
10	Sale of all or substantially all of a corporation's assets outside of the regular course of business is a fundamental change which must be approved by the directors at a meeting. Then it must be approved by a majority of all outstanding shares entitled to vote
5	Director's meeting was not properly called because not reasonable notice
5	Chuy participated in the meeting, which probably waives defective notice
5	Zoom attendance is adequate. Physical presence not required.
	Cure
5	E and D could notice a new director meeting and disclose the conflict of interest.
5	However, interested directors cannot vote, so C would have the only vote at the new meeting.

10 The board, including E and D, could vote to submit the decision directly to the shareholders.

Minority Rights

5 E and D will likely be able to force the sale because they are a majority of the board and they hold a majority of the shares.

10 A, B and C will have the right of appraisal of their shares because they hold a minority of the outstanding shares.

5 A, B and C must vote against the proposal, file a written objection and a written demand for fair value of their shares.

5 Majority shareholders owe the minority a duty not to profit at the minority's expense. If A, B & D can prove that the sale price was substantially below the true value of the assets, a court could find that D & E breached this duty and award damages, or even set the sale aside.

Question 3 Issues Checklist

Points	Issues
	<u>REO's Liability</u>
10	REO is liable for breach of the purchase, rent and insurance obligations. Its dissolution does not eliminate its liability. Dissolved corporations can still be sued.
10	The assignment contract was signed by REO's president, and REO's secretary certified the president's authority to enter the deal. But the contract relieved the President of his obligations to TSquare, so it could be a breach of his duty of loyalty. This may invalidate the assignment contract and leave Alta liable on the original deal.
15	Although purchase of the assets of another corporation is probably not in the ordinary course of business, at least two of the three shareholders were obviously in favor and therefore it was approved by a majority of the outstanding shares. Although Alta was not entitled to vote as a director on the assignment contract, he was entitled to vote as a shareholder despite his self-interest.
5	Nevertheless, as President, certified by the Secretary, Alta had apparent authority to bind REO, and TSquare was entitled to rely on that authority.
	<u>Alta's Liability</u>
10	Alta is probably not liable on the original purchase contract he signed on behalf of a corporation to be formed later. TSquare knew that it was dealing with a corporation and not with Alta individually, and it later agreed to a novation by REO. Further, TSquare asked Alta for a personal guarantee, which suggests that TSquare did not consider Alta to be bound individually.
	<u>Piercing the Corporate Veil</u>
10	REO seems to have been inadequately capitalized. $2500 was not sufficient to cover the costs of operating REO. We don't know the revenues that TSquare would generate, however.
5	The shareholders did not observe the corporate formalities. No minute books and corporate records.

Lack of formalities, without more, is not sufficient to pierce REO's corporate veil. There must be some injustice resulting from it. Here, the absence of records may have prevented TSquare from determining REO's financial condition.

Also, the shareholders used the corporate shield to perpetrate a fraud on TSquare. They refused to sign personal guarantees, intending for REO to be the only liable party, and then they misrepresented the assets of REO.

Finally, if TSquare obtains a judgment against REO, the dissolved corporation, it can trace the assets to the shareholders who received them, Alta, Benoit and Choate, and recover the value of the assets from them.

Fraud

Benoit clearly misrepresented the assets of REO to induce TSquare to agree to the assignment to REO. Directors are personally liable for torts they commit in their capacity as directors.

4Roses

EC A purchaser of assets is not liable for the selling corporation's debts and obligations unless it expressly assumes them. There is no evidence that 4Roses did so.

Business Org / Spring 2020 / Q1

In order to know if contracts made by Karl were binding and Mr. A possibly liable the court would need to find that Karl was an agent operating on behalf of Mr. A.

Agency

Agency is the law that underlies business organization and it allows people to delegate responsibilities to other individuals. An agency involves a principal, or the person/entity (that owns the company or business entity) and an agent, or the person that can perform on the behalf of another person, making the other person liable for their actions. A person can give an agent actual authority which can be expressed (stated out loud or written) or implied authority where the agent's conduct has been alone in the past and no one has objected, or its inherent in the job, and it's reasonable to the agent to believe that he has that authority. There is also apparent authority which is what a third party believes/renders as authority from an agent

Was there an agency relationship?

Mr A contracted to compel to Karl the authority to seek out produce and to enter into contracts to Solid Growers with other additional terms. a Defined Agency relationship exists merely by fact that a certain relationship exists (such as a corp., partnership, employer/employee) but Mr A's and Karl had a contract which would be different than that. Their relationship is a Proven agency because there is consent from both parties to the relationship, control in which the agent is responsible to some basic instruction from the principal and some basic

cont.

instruction of a principle; must distinguish between the principal's control and his own; and that there is a scope which limits the actions of the agent on behalf of the principal. Here, Mr A and K consented to the agency. Kael was in control of getting contracts and he was told the scope of what he could do there was a Proven Agency between them. Furthermore, Mr. A took an ad on the paper that openly declared that K was his agent with authority to contract on its behalf even if it didn't go into details. Under these facts there was a valid agency between Mr A and Kael.

Tipsy Turnips

K contracted for a 3month supply of Rutabagas for $10,000 and at the time of the contract formation he had the express authority to enter into contracts for less than 6 mos. duration and no more than $15K. The contract with Tipsy Turnips falls within the scope of the authority given in the agency, so Mr. A ~~be~~ was bound by contract and has to pay for the rutabagas.

Chuy's Produce

Kael contracted for a 1yr supply of baby vegetables from Chuy at "market price". In this scenario, Kael exceeded the scope of authority because he only had to contract 500 noodles and a $15K limit. Arguably the "market price" could be less than the limit but that is speculative, so he potentially exceeded the scope of the agency and definitely exceeded on the length of the contract basis.

cont.

Because Kael worked out of the scope of his authority he bound himself as well as Mr. A to any liability. Mr. A will try to say only Kael is liable to Chevy because he exceeded his scope of agency authority but Chevy had no notice that there was a limit to the agency because the act didn't disclose the terms so Mr. A is also liable in this instance, he should have notified prospective contracts of the full terms of the scope of authority, otherwise the companies would reasonably believe Kael owned contract to those terms. The law will likely protect the third party's interests and in this case for lack of notice Mr. A and Kael are equally bound and liable for the contract.

Tyson's Food

Kael entered into a 3mos contract for chicken parts for less than 10K and a secret side agreement to be employed by Tyson for tv endorsements. Although part of the contract falls within the scope of authority of the agency, Kael's employment agreement is not part of it and it also points to self-dealing in the transaction. An agent has fiduciary duties to the principal that include duty of care, duty of loyalty and duty of obedience. Kael failed this duties because by secretly benefiting from the contracted transaction he didn't do the job he said he would do, he broke his duty of loyalty because he didn't put Mr. A's interests in front of his own and he breached his duty of ~~of~~ obedience because he didn't do what Mr. A told him to do, he exceeded his orders. Because Kael breached his fiduciary duties Mr. A has the right to repudiate the contract and then Kael would be liable

because of this Mr A may not be bound. Tyson will argue that the contract is valid because the terms were within the scope, but Tyson knew the scope of agency was for the ~~contractor~~ supplies and not for any separate deals that Karl might do so they have unclean hands. It is likely that the court will find that Karl's breach of his duties release Mr. A of this contract.

In the end Mr A must pay Toppy Turnip the contracted amount, ~~the~~ he may be bound along w Karl at the court's discretion to Chuy and will not likely be liable to Tyson.

Business Organization/Spring 2020 / Q2

In this scenario involving CBD, Inc. there are shareholders that manage the business and a small number of shareholders so this is a small closed corporation and as such they have a similar setup to corporations but sound more like a partnership. One of the things that will be relevant is that the directors have fiduciary duties to the corporation which will be further discussed. Andrew (A), Billy (B) and Chuy (C) together own 45% of the shares of the corp. and are a minority. However because they think that the sale of the corp. is not in its good interest then they could bring a derivative action ~~to stop the sale~~ at a later date if there is a loss to the company but prior to that they can say that there should be an appraisal of the stocks to make an informed decision, because they are a minority and the Fairness test applies. If these things fail they can proceed with a derivative action.

Derivative action

A, B + C can initiate a derivative suit in order to stop the sale and the must first give a demand letter and notice to the board, which it seems that they will ignore to proceed with the sale, and they claim the corp will incur losses and the others are breaching their fiduciary duties to the corp for failing to get the best price for the sale by not inviting offers from other competing buyers. The demand requirement helps the directors cure whatever the problem is and minimizes the shareholders possible grievances. AB+C will argue that by not opening bids to get other offers procedural defects are present

and because some of the shareholders were not informed of negotiations or in agreement then there are substantive defects with the sale. A, B, C will argue that because they are a closed corp you can't rate per same transaction in which the majority holders benefit and the minority shareholders don't, the majority owes a duty to look out for the minority and they should have an equal opportunity.

Oppression

occurs when there is a majority of shareholders that take action that is not in the best interest of the minority. but D+E can argue that ABC will benefit from the transaction and there is no oppressive conduct the court would look to the reasonable expectations of the minority which was to get the most for their stocks in a sale, but the majority will argue that that is a good price and not change their actions. Because there was no other offer for the company if D,E go on with the sale that would be oppression. Although they could offer to buy ABC's stocks, but they probably won't want that since they don't have to sell.

Entire Fairness Test

Because a majority is oppressing the minority The Entire Fairness Test will have to be met in The ~~sale~~ buyout, but there doesn't seem like ABC want that so doesn't apply

2. D/E owe of defects

K+E could do an appraisal of the stocks and open to accept offers from other companies in order to inform the others. They can also be transparent about their negotiations and disclose their agreement to the other company to remove any claims of breach of fiduciary duties or that they incurred any benefits. They could use the business judgment rule to say the sale is in the best interest of the company. They would have to disclose that they are interested directors, and to CC of the benefits they would get to correct any possible violations on their part. They can wait longer to sell to explore options.

Freeze Out

Here the majority is trying to push out the minority and the Wilkes test must be met, to show that action taken leading to the freeze out was a legitimate business decision and that there was no less injurious alternative. DE were motivated by selling to capitalize the company's stocks and kept a duty of utmost good faith throughout their actions.

3 Assuming DE can force the sale then ABC can assert their rights by demanding that they are given fair dividends between the majority and minority which wouldn't be hard because they are not so different. The majority is 55% and the minority is 45%

ABC could demand to get the fair price for their shares which is always the highest price. ~~Also they can make them to correct their interested status by~~

Rule 10b5-

The directors DE would have to disclose their interests so were apart of ~~rule~~ rule 10b5 because they omitted facts to the others so again they would have to correct that

Business Organizations / Spring 2020 / Q3

1. Alta may be liable to TSquare because she signed the contract as president of REO but also as an individual. Alta had been involved and took initiative in funding, founding, and organizing the corporation so she is considered a promoter and promoters could be held liable for the debts they contract on behalf of the to be formed corp (it wasn't fully created when she signed but she made negotiations based on the corp. to be formed later) even though the corp wasn't formed the corporation later accepted when it was formed and assumed Alta's obligations. Alta will claim that she meant to sign only as promoter not as an individual and she could which can be proved because there was a certificate that Alta could sign on behalf of REO, so it would exempt her from personal liability. In corporations the personal assets of board members are not open to liability so Alta will not be liable, REO is liable for the breach to TSquare

2. TSquare was not able to get personal guarantees from any of the shareholders so this puts it in a position of disadvantage because board members are not liable for the corporation, their personal assets are protected. Without the guarantee TSquare has no way of going after their personal assets and they should have declined to engage in business with them if they had no way to protect themselves from breaches such as the one that did occur. ~~Next question~~ Heard Martin

3. RED kept no minute book and no corporate records and that might be in TSquares favor because they can make the claim that the corporation was defective and there wasn't a good effort attempt to incorporate. ABC would then have to prove that they were a legitimate corporation and that they did in good faith try to carry out the purpose of the corporation, but it will be hard because lacking minute books and records it shows that they were not doing their fiduciary duties as officers and they did not intend to have the corp but their conduct reflects neglect of their duties and gives TSquare more weight in their claim

4. Banoit showed that RED had a net worth of $100,000 when in fact it had ~~$5~~ $2500 in their account. TSquare can claim that Baction constituted fraud and misrepresentation and to show that the corp ~~was~~ did not have adequate capitalization. This would pierce the corporate veil ~~in order~~ which is a mechanism that creditors rely on to hold shareholders liable for corp's debts when it becomes ~~in~~solvent. It is generally accepted that shareholders will be personally liable for their corp obligations if at incorporation they fail to provide adequate capitalization. This undercapitalization also undermines the creation of the corporation and strengthens TSquares claims against ABC.

~~5. TSquare is~~

Based on the evidence the court will think that it is adequate to pierce the corporate veil ~~and~~ because it was undercapitalized and the directors knew it, also Shareholders failed to maintain adequate records or ~~of~~ failed to have corporation formalities (like records and minutes). For this reason it is likely the court will allow that ~~the~~ ABC each be liable (personal assets) to TSquare because they did not behave properly through their personal acts and conduct. Since all three were aware ~~of the~~ and had a duty to be aware of the status of the corp. AC can argue that B was the one that showed TSquare the accounts misrepresenting the assets but they knew the truth since they only invested $2.5K. TSquare will show that there was a unity of interest or a total disregard for the separate existence of the corp (no records, no minutes) and that there will be an injustice if the corporate veil isn't pierced to hold them liable and the court will probably agree with that assertion.