

Business Organizations II

Final Examination

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Instructions:

There are Three (3) questions in the examination.

You will be given 3 hours to complete the examination.

Question 1

After years of perfecting their homemade craft beer recipes, a group of friends: Frank, Franny, and Fred, from California have decided to take their passion for brewing to the next level and start a business. Frank, Franny, and Fred have chosen to form a corporation to take advantage of the limited liability protection and potential for growth through the sale of shares. The friends hired Adam Attorney to incorporate their business under the name "Brewski Bros". Adam Attorney properly prepared all necessary documents to incorporate the business but carelessly failed to file them with the Secretary of State.

Frank, Franny, and Fred believed they had formed their corporation and continued operating as if their enterprise had been properly incorporated, including entering into a 3-year lease with Lenny Landlord in the name of Brewski Bros.

Due to mismanagement, Brewski Bros went out of business 6 months into operation and had to break the lease. Lenny Landlord wants to go after Frank, Franny, and Fred personally.

Please discuss the following:

1. What are the legal requirements for forming a corporation in California?
2. What type of enterprise is Brewski Bros?
3. Will Lenny Landlord be able to successfully sue Frank, Franny, and Fred personally for breaking the lease?

QUESTION 2

The Hercules Corporation is a corporation that owns a number of outdoor fitness obstacle courses. The appeal of Hercules Co. gyms and courses was the unique experience where you feel like you are exercising in another world. With 10 shareholders total, Zeus owns 20% of the shares, while the other shareholders own between 5% - 10% of the rest of the shares.

Hercules Co. has a very popular outdoor course that is surrounded by apartment complexes. Zeus, who is also the president and director of the Hercules Co., has owned the apartment complexes since before he became a shareholder, president, and director of the corporation. He also disclosed to the Board when he purchased shares that he was the owner, and the Board did not see a problem with it.

The apartment complexes are out of date and are being overshadowed by the Hercules Corporation's outdoor facility. Zeus would rather sell the property and give the corporation a chance to claim the property and expand the outdoor facilities. Zeus schedules a meeting with the Board to discuss his idea to expand the corporation's business.

Zeus discloses that he believes the fair market value of his property is approximately \$1.25 million, and wants to sell the property to the corporation so they can expand upon their very popular outdoor course. Zeus also estimated that the after purchasing the property, developing the property, and opening the course, the corporation would make a profit of approximately \$2 million within the next year. Trusting Zeus and liking the idea of making a profit, the Board approved the transaction and appointed Hades, another shareholder and director, to close on the property.

Zeus sold the property through an agent, who worked directly with Hades on closing the property. The agent appraised the property and discovered the value of the property increased to \$1.5 million. The agent brought this to the attention of Zeus who said, "Shouldn't be a big deal. I told them the price was approximate and they will still make a profit." The agent subsequently told Hades that the value of the property increased to \$1.5 million, and they could not sell for any less. Hades, thinking that the extra \$250 they'd be spending wasn't a big issue, agreed to purchase the property.

Hercules Corporation proceeded with the expansion project, but ran into some unexpected issues developing the property, which cost them an extra \$250,000. After the development of the property was complete, the Hercules Corporation only profited \$1 million from the transaction, resulting in a \$750,000 loss.

A derivative suit was filed against Hercules Corporation's Board of directors for breach of their fiduciary duties.

Will the directors of the Board, Zeus, and/or Hades be protected from liability by the Business Judgment Rule? Discuss.

Question Three

The Viking Company of California (Viking) operates a landscape and construction business. The company is owned by three brothers, Ragnar, Floki and Ivar, who are equal shareholders. They are also the directors of the company. Business is very good and the company has a lot of cash on its balance sheet. It also carries a large and expensive insurance policy to cover the risks in its business.

The brothers realize that there is a brisk market in the sales of used construction equipment. They form the Freya Company (Freya) as a wholly-owned subsidiary of Viking with only the minimum amount of capital required to incorporate and issue \$3,000 in capital stock to themselves (1,000 shares each). They are also the directors of Freya. Freya uses the same address as Viking. They hire Bjorn to run the business. Bjorn told them he had “a lot of experience” with rebuilding equipment, but did not provide any references, nor did they ask for any. The advertisements for Freya state that the company is fully-bonded and insured.

During their first board meeting, the directors of Freya decide, even though it is a high-risk business, to delay obtaining an insurance policy for any liability as the premiums are so high. They decide to wait to see if the business grows. The notes/resolutions of the meeting are printed on Viking letterhead, and signed by the three, all using the title “director” with no other designation. The bylaws are a copy of Viking’s with just the Company name changed.

The first week Freya is open, Bjorn fixes up a tractor and sells it to Eric, a sole proprietor/farmer. Two days later, the tractor breaks and Eric is injured and unable to work for an extended period. Eric files a personal injury suit against Viking. Viking counters that it is not liable as it is a completely separate company and that the proper party is Freya. Eric also sues Bjorn.

What might the court decide?
