

**Professor M. Jonathan Hayes**  
**Fall 2018**  
**December -, 2018**  
**6:30-8:30 pm**



**University of West Los Angeles**  
**Final Examination**  
**Business Organizations**

Answer both questions.  
Time allotted: **Two Hours**

If you are writing your exams, please use a separate bluebook for each question. Be sure your handwriting is legible.

Each question will count for one-half of the total grade for the final examination.

Your Answer should demonstrate your ability to analyze the facts in the question, to tell the difference between material facts and immaterial facts, and to discern the points of law and fact upon which the case turns. Your answer should show that you know and understand the pertinent principles and theories of law, their qualifications and limitations, and their relationships to each other.

Your answer should evidence your ability to apply the law to the given facts and to reason in a logical and lawyer-like manner from the premises you adopt to a sound

conclusion. Do not merely show that you remember legal principles. Instead try to demonstrate your proficiency in using and applying them.

If your answer contains only a statement of your conclusions, you will receive little credit. State fully the reasons that support your conclusions, and discuss all points thoroughly.

Your answer should be complete, but you should not volunteer information or discuss legal doctrines which are not pertinent to the solution of the problem.

Unless a question expressly asks you to use California law, you should answer according to legal theories and principles of general application

## QUESTION 1. (50%)

Beth, Charles, and David are the directors of Web, Inc. (Web), a corporation that is in the business of creating websites. Web has 100 shareholders. It is not a close corporation.

Adco, Inc. (Adco), a corporation that markets computer advertising, wanted a complex website that would cost \$25,000 to create. Abraham, Manager of Advertising for Adco, approached Web about creating the website. Abraham explained that Adco did not have the cash to pay for the work but falsely claimed that Adco was a well-established corporation and asked Web to extend credit for the work.

Beth, Charles, and David unanimously agreed to take on the work, conditioned upon a prior review of Adco's financial statements and a determination of Adco's credit-worthiness. David was anxious to obtain Adco's business. He falsely told Beth and Charles that he had reviewed Adco's financial statements and that, based on his review, "we should proceed with the work." Beth and Charles, without further inquiry, agreed, and Web created the website which Adco is using. Adco has not paid because it says Abraham was not authorized to enter into the contract for Adco. Adco has also told Web that it has no money to pay the charges anyway.

In an unrelated transaction, Charles received a call from his friend Sam who wanted Web to create a new game website. Charles told Sam that the new game website was such a small job that he could do it at home for less money than Web.

Charles told Sam to send the payment for the game website to Charles at his home. Sam was pleased with the work and sent the check to Charles as requested. Shortly afterwards, Beth and David learned of this transaction.

1. What duties to Web, if any, have been breached by Beth, Charles, and David regarding the money lost on the Adco job? Discuss.
2. What rights, if any, does Web have against Adco or Abraham regarding the contract with Adco? Discuss.
3. What rights, if any, does Web have against Charles regarding the contract with Sam? Discuss.

## Analysis

1. Beth, Charles and David owe fiduciary duties of care and loyalty to Web. They have to use good faith business judgment and reasonable care when they make decisions on behalf of Webco. They will be protected by the business judgment rule if they do reasonable due diligence and there is no conflict, fraud, illegality, waste or bad faith. Due diligence is what a reasonably prudent person would do under the circumstances. We can't tell how much due diligence they did but we are told that they unanimously agreed, subject to a credit check, to do the work. B and C decided to rely on D to do the credit check. Is that what a reasonably prudent person would do under the circumstances? That would probably depend on how big a job this is compared to how big the company is. If this one job could kill the company, probably more due diligence would be required.

As to B and C, I think they did sufficient due diligence. They had the right to rely on D unless there was some reason he was unreliable. Since there are no facts suggesting there was a conflict, illegality etc, I think they are protected by the business judgment rule.

As to D, he lied to the other directors. That is sufficient to deny him the benefit of the BJR. Did his conduct cause the injury? It did unless somehow Webco gets paid for the work. Therefore he breached his fiduciary duty of care to the corp.

There are no facts with respect to the Adco transaction that suggest a breach of loyalty. None of them received any personal benefit at the expense of the corp.

2. Webco has the right to be paid for the job unless Abe did not have authority to bind Adco to the contract or there is some other reason why Adco should be bound. If Abe did not have authority and therefore Adco is not bound, Abe may be liable to Webco for misrepresenting his authority.

There is no express authority to bind Adco to this particular contract. But Abe is Manager of Advertising therefore he has *some* authority. If he reasonably believes that his authority as Manager includes entering into these types of contracts, then there is actual authority called implied actual authority. The only facts we are given is that Adco said Abe wasn't authorized. I would say that it is reasonable that a Manager of Advertising has authority to contract for a website (although the facts don't say the purpose of the website was advertising).

If there was no actual authority, there may be apparent authority. What did Adco do that gave Webco the reasonable belief that Abe had authority? The only fact we are given is Abe's title. I think that is enough because it is advertising and this seems to be advertising. One exception to that would be that this was such a large

transaction to Adco that only the BOD would have actual authority. There are no facts to suggest that.

The facts say that Adco is using the product. If Adco knew of the terms of the contract and accepted the product and is using it, Adco has ratified the transaction and is bound by the terms.

3. As to Charles, it appears he has usurped a corporate opportunity. Webco is "in the business of creating websites" and that what the contract with Sam is. Charles has breached his fiduciary duty of loyalty by taking something that rightfully belongs to the corp. Sam's only possible defense is that the BOD of Webco would have rejected the opportunity because it was so "small." But this only goes to damages. He clearly breached the duty of loyalty.

### **Comments:**

1. As to 1, most students discussed the duty of care reasonably well. Many though confused the duty of care with the BJR. This question, as to B and C, was completely about due diligence. They are protected by the BJR if they did due diligence. D obviously did not. Many said there was a lack of due diligence on their part. I am fine with that conclusion but saying there was sufficient due diligence was also fine. Many students discussed piercing the corp veil which was a waste of time. If Webco sues B, C, and D, there is no veil to pierce. They are individuals. Many students went on and on about the duty of loyalty. There is no loyalty issue in part 1. Students talked about throwing B, C and D off the BOD - not an issue - question was "what duties have been breached?"

2. As to 2, students seemed to either know about authority or not. Many of those who did seem to know the rules, missed ratification. Again, many students discussed piercing the corp veil, loyalty.

3. Most students did a decent job on Charles stealing the corp opp. Many went on and on about the safe harbor and how he should have done that. Spending time on that doesn't hurt but it wasn't worth a lot of time. The question was what rights does Webco have against C, not what should C have done.

### **QUESTION 2. (50%)**

Judson worked for The Tax Professionals for the past 5 years, preparing tax returns. He decided to leave and start his own tax return preparation business. He properly forms a corporation, Judd's Tax Service, Inc.

A few months into his new venture, he is struggling. He is behind on the rent and behind on other bills. He meets Robert, also a tax return preparer, and they agree that Robert will join Judson in the business. They agree that Robert will receive 50% of the profits each year.

To find tax clients, Judson starts a blog which falsely states that he has 20 years of experience doing tax returns and tax audits. He has never done a tax audit. Tina sees the blog and hires him to handle her tax audit.

As business is slow, Judson posts on the blog one day that he is expanding and if someone will loan him \$100,000, he will pay them 10% interest per year and repay the loan in full in one year. Donald responds and makes the loan. The promissory note is signed by Judson as President of Judd's Tax Service, Inc.

After one year, Robert leaves because he believes that Judson is making more money than he says and not paying the 50% promised.

1. Tina now believes that her audit was mishandled by Judson. Who can she sue, on what basis, and what is the likelihood of success?
2. Donald has not been paid. Who can he sue, on what basis, and what is the likelihood of success?
3. Robert wants to sue to collect the 50% he was promised. Who can he sue, on what basis, and what is the likelihood of success?

### **Analysis**

1. Tina entered into a contract with someone or some entity. She can sue that person or entity for breach of contract. Also, according to her, someone or some entity committed malpractice (negligence), and Judd committed fraud.

As to breach of contract, it is not clear who the contract is with. Since J formed a corp, J's Tax Service, the contract was probably between the corp and Tina. If it was between J and T (unlikely), T can sue J for breach of contract. It is possible that J and R formed a partnership and IT entered into the contract with Tina. A partnership is an agreement to operate a business together for a profit. All we know from the facts is that R will "join J in the business" and get 50% of the profits. If there is a partnership, and Tina entered into contract with it, she could sue it for breach of contract. If the partnership is liable for the debt, then both partners are also liable.

As to the purported malpractice, the analysis is the same except that Judd would be liable for malpractice as well as his employer, i.e., the corp or the partnership. Judd personally had a duty not to "mishandle" the tax audit.

Tina can also sue Judd and his employer for fraud. He falsely told her he had more experience than he did. If she reasonably relied on that to her detriment, he would be liable for her damages. His employer would also be liable for the acts of its agent, Judd. Same if J and R formed a partnership.

If the audit was actually mishandled, Tina would win against Judd and his employer because of his malpractice. Presumably the malpractice would be a breach of contract as well. Tina will win against Judd and his employer as to the fraud.

I don't think Robert is liable for anything other than he will be personally liable for any debt that the partnership owes.

I also don't think there is a partnership. "join the business and you will get 50% of the profits" seems to assume the corp owns the business and therefore there cannot be a partnership because it would not own the business. This appears to be an employment agreement between the corp and Robert.

2. Donald can sue the corp for breach of contract - it breached by not paying him back. He could sue the partnership (assuming there was one) but since the note was signed on behalf of the corp, it seems hard to say there was a partnership debt.

Donald can also sue Judd (and the corp) for violation of securities laws. The loan is clearly the sale of a security because it is an investment contract, an investment where repayment with a profit depends entirely on the efforts of others. It is also clearly a sale to the public since Don has no information on the company or Judd, and has no preexisting relationship with either.

Again, I believe Robert has no risk unless the partnership is somehow liable to Donald either on the loan or for violation of securities laws. Then he would be liable as a partner.

3. Again, someone promised Robert 50% of the profit. Whoever made the promise, Judd, the corp, or the partnership would be liable for breach of contract - if there were a breach. Judd made the promise but was it on behalf of himself or the corp? presumably the corp. If the agreement between Judd and Robert created a partnership, then it would be liable if the 50% were not paid and since it is liable, Judd would also be liable.

## **Comments:**

1. Many students either assumed there was a partnership and discussed little else or ignored the issue entirely. A few students talked about whether J or R breached their fiduciary duties even though Tina would have no standing to bring that action against them.
  
2. Probably a third of the class missed completely the securities law issues in part 2. If there were no securities law issues, only the corp is liable. Some students discussed whether Judd had authority? He was the President of the corp! Furthermore, the corp got the money and apparently used it - i.e., ratification.
  
3. As always, many students were out of gas by the time they got to part 3. That is a big mistake. Part 3 was one-sixth of the whole exam. But the answer is pretty simple - the promise to pay him created a contract. Whoever the other party to the contract was would be liable.