

July 2000

**QUESTION 7**

Daddy Warbucks is the sole officer, director, and shareholder of Cars Are Us, Inc., a duly formed and operating Texas corporation. Cars Are Us specializes in buying and selling rare automobiles.

Cars Are Us inadvertently failed to pay its Texas franchise tax, and its right to do business was forfeited on May 1, 2000. On June 1, 2000, when Warbucks realized the oversight, he paid the tax, and the right of Cars Are Us to do business was reinstated as of June 1.

On May 10, Warbucks had learned that Dealer owned a very rare Rolls automobile that he was trying to sell. Warbucks was interested in acquiring the Rolls for Cars Are Us but was concerned that, if Dealer knew that Cars Are Us was the buyer, Dealer would inflate the price.

Warbucks asked Annie to present herself to Dealer as the buyer without telling Dealer she was acting for Cars Are Us. Warbucks said Cars Are Us would give her the money to pay for the Rolls. Annie is a minor.

In order to pass herself off as an adult, Annie went to Dealer's showroom on May 12, 2000 wearing clothing and make-up that made her look older. Although Dealer did not ask her, Annie told Dealer she was twenty-one. As far as Dealer knew, Annie was buying the Rolls for herself, and Annie did not tell him otherwise. As instructed by Warbucks, Annie signed a contract agreeing to buy the Rolls.

On May 16, 2000, Warbucks changed his mind, told Annie that Cars Are Us no longer wanted the Rolls, and refused to give her the money to pay for it. Consequently, Annie told Dealer she would not honor the contract to buy the Rolls. Dealer later found out that Annie had been acting on behalf of Cars Are Us.

**What are Dealer's rights, if any, to recover for breach of contract against:**

- 1. Annie? Explain fully.**
- 2. Cars Are Us, Inc.? Explain fully.**
- 3. Warbucks? Explain fully.**

### **Question 7 - Business Associations**

Many examinees did not know that failure to pay franchise tax results in personal liability on officers and directors for corporate debt. *See Section 171.255 (a) Texas Tax Code.*

Very few examinees dealt with the fact that Annie intentionally led the dealer to believe that she was an adult, and they did not discuss potential estoppel issues.

Numerous examinees discussed the Deceptive Trade Practices Act, which had nothing to do with the facts presented.

July 2000

**QUESTION 8**

Art, Ben, and Cal formed Land Venture Associates (“LVA”), a general partnership, for the express purpose of building and selling an office building on land they had acquired and transferred to LVA. The partnership agreement contained the following terms: Art, Ben, and Cal each agree to contribute \$300,000 to the partnership capital account; Art agrees to provide LVA with all architectural services in connection with the project; Ben agrees to furnish all accounting services; Cal agrees to furnish all marketing services; and the death of a partner is not an event of dissolution.

Within a few days after LVA was formed and after the partners had made their capital contributions, but before any of the money had been spent, Art announces to Ben and Cal that he wishes to withdraw. He says he believes the project is too speculative and that he will not perform the architectural services. He also demands that his \$300,000 capital contribution be refunded. LVA refuses Art’s demand for an immediate refund.

Art files suit against LVA seeking to force an immediate refund of his \$300,000 capital contribution. Ben and Cal are not named as parties to the suit. LVA, having determined that it will cost \$150,000 to obtain the architectural services necessary to carry out the project, files a counterclaim against Art for that amount.

As the litigation progresses, Art and LVA reach a tentative settlement agreement. While the lawyers are still working on the settlement papers, Ben dies with a valid will that leaves all his property to his widow, Doris. Doris does not agree with the terms of the settlement agreement and insists that LVA continue the litigation with Art.

- 1. Is LVA liable to Art for the immediate return of his \$300,000 capital contribution? Explain fully.**
- 2. Is Art liable to LVA for the \$150,000 cost of replacing his architectural services? Explain fully.**
- 3. May Cal proceed with the settlement agreement despite Doris’ opposition to it? Explain fully.**

### **Question 8 - Business Associations**

The facts stated that the partnership was for a particular purpose. Examinees failed to recognize that if a partnership is for a particular purpose a partner cannot withdraw at will, and if a partner withdraws before the completion of the term or purpose, the withdrawing partner is liable for damages caused to the partnership and does not have the right to compel return of capital contribution until the partnership ends. *See Arts 6132b-7.01 (k) & 6132b-6.02 (c).*

February 2001

**QUESTION 5**

Randy and Sam Hoot want to open a retail store to sell cowboy boots. They want to call the business “Hoot’s Boots.” They have entered into a written agreement that contains the following terms:

- (a) All management decisions must be made jointly by Randy and Sam;
- (b) Sam will be the sole employee and receive a salary to be agreed upon annually between Randy and Sam;
- (c) Randy will have no liability for any aspect of the business;
- (d) Randy will advance \$100,000 as operating capital and will receive the first 5% of the profit from the business each year;
- (e) Before any profit, other than the first 5% referred to in subpart (d), can be distributed, Randy and Sam must mutually agree whether and how much of the profit is to be distributed and how much is to be retained for use as operating capital; and
- (f) If Randy and Sam decide to distribute any of the profit, it is to be distributed equally between the two of them.

- 1. Do the terms of their agreement prevent Randy and Sam from using any of the following business associations as the legal entity for Hoot’s Boots:**
  - (i) A general partnership? Explain fully.
  - (ii) A limited partnership? Explain fully.
  - (iii) An L.L.C.? Explain fully.
- 2. What steps must Randy and Sam take in order to be able legally to use the name “Hoot’s Boots?” Explain fully.**

### **Question 5-- Business Associations**

Some examinees did not seem to understand the differences between a general partnership and a limited partnership, to wit:

- There are no limited partners in a general partnership.
- A limited partnership cannot be comprised of solely limited partners.
- A limited partner in a limited partnership is at risk for the amount invested in the partnership. An investor, regardless of the business entity chosen, is always at risk for the amount invested.
- A limited partner cannot participate in management or control of the limited partnership.

Some examinees did not appear to understand the Limited Liability Corporation ("L.L.C.") entity:

- An L.L.C. is not a business form that is restricted to lawyers, doctors, or other professionals.
- An L.L.C. operates with fewer formalities than a traditional corporation.
- An L.L.C. is managed by either members or managers.

A business, even if an L.L.C. or a limited partnership, can transact business under an "assumed name" provided that the assumed name is registered with the Secretary of State and the appropriate County Clerk.

**QUESTION 6**

Goats Are Us, Inc. is a Texas corporation. Its articles of incorporation state: "This corporation is a close corporation." Goats Are Us sells goat meat, goat milk, and other products processed from goats to the health food inclined public. There are 100 issued and outstanding shares, of which Father owns 90 shares and Daughter owns 10 shares. Daughter is a salaried employee of the corporation.

Goats Are Us has no board of directors and no bylaws, but there is a shareholders' agreement signed by Father and Daughter that includes all of the provisions the law requires bylaws to contain. That agreement also states: "All financial and business decisions of the corporation shall be made by Father and are reserved exclusively to Father. No person who acquires corporate stock by transfer or assignment shall thereby acquire any right to participate in the management or administration of the corporation."

To ensure a steady supply of goat products, Father contracted with Tee, a local goatherd, to sell products to the corporation at fixed prices. As part of the consideration, Father conveyed to Tee 50 of Father's 90 shares in Goats Are Us. Tee had no knowledge of the shareholders' agreement at the time of the conveyance, and Father said nothing about the restrictions on the shares.

The business is four years old, has earned increased profits each year, and has an earned surplus of \$125,000. At the next legally called shareholders' meeting, Tee made three motions: (1) that a dividend be declared; (2) that the corporation increase the prices paid for his products by 15% (which is in fact a reasonable price); and (3) that Daughter's salary be reduced by 20% (which would still in fact be a fair and reasonable salary). Tee voted his 50 shares in favor of his motions, and Father voted his 40 shares against them. Daughter abstained.

Father then moved (1) not to declare a dividend; (2) to increase Daughter's salary by 20%; and (3) to lower by 15% the prices paid for Tee's products. Father voted his 40 shares in favor of these motions, and Tee voted his 50 shares against them. Again, Daughter abstained.

- 1. Is it lawful for Goats Are Us to operate without bylaws and without a board of directors? Explain fully.**
- 2. Which set of motions, Father's or Tee's, prevail? Explain fully.**
- 3. Do shareholders of a close corporation owe one another any fiduciary duty? Explain fully.**

## **Question 6-- Business Associations**

Some examinees did not demonstrate knowledge of the differences between a close corporation and other corporate entities:

- A close corporation is not the same as a "C" corporation;
- A close corporation is not the same as an "S" corporation;
- Close corporations are governed differently than traditional corporations;
- Close corporations may be run with a lesser degree of formality than traditional corporations;
- Shareholder agreements in close corporations are different than shareholder agreements in traditional corporations.

Some examinees did not seem to understand the nature of fiduciary duty:

- There is no such thing as a fiduciary duty to be profitable;
- Shareholders in a publicly traded corporation do not stand in a fiduciary relationship to other shareholders;
- Fiduciary duty may apply in a close corporation between a majority shareholder and a minority shareholder in circumstances of shareholder oppression;

Some examinees did not appear to know what the functional parts of a corporation are, and how they interrelate:

- A Board of Directors does not manage the day-to-day activities of a corporation;
- Shareholders may manage the day-to-day activities of a close corporation by agreement;
- Shareholders do not manage the day-to-day activities of a traditional corporation;
- The President and Secretary of a corporation are not necessarily directors - they are officers of the corporation.

July 2001

**QUESTION 1**

A & B was a general partnership for the practice of law. The partners were A, B, and C.

In January 2001, C, in the course of representing X in a legal matter, committed malpractice. In February 2001, C was convicted of possession of cocaine, and A & B lawfully voted to expel C from the partnership.

In March 2001, D joined the A & B firm as a partner and, as is customary upon joining a law firm, D contributed \$30,000 as his share of the firm's capital account to be used for operating funds.

X has learned of C's malpractice and wishes to sue for damages, which, at a minimum, equal \$1,000,000. Neither the A & B partnership nor any of the partners carry professional liability insurance, and the partnership's current assets are less than \$100,000.

**Explain to X the extent of the liability for damages resulting from C's legal malpractice as to each of the following:**

- 1. A & B Partnership.**
- 2. A & B individually.**
- 3. C individually.**
- 4. D individually.**

### **Question 1 – Business Associations**

The questions that were asked dealt entirely with liability. Many examinees discussed the desirability of insurance or alternative business entities. Just answer the question asked. Do not wander. A number of examinees appeared to have difficulty with the following concepts:

- A general partnership does not have limited partners.
- Joint and several liability does not restrict a plaintiff from recovering more from one partner than another.
- A partner in any type of partnership is always responsible for torts he committed personally.
- A partner who becomes a member of a partnership after a tort is committed is not personally liable. His capital contribution is, however, at risk.

July 2001

**QUESTION 2**

Greek Stuff Inc. (GSI) is a corporation legally formed in the State of Texas. GSI is not formed as a close corporation. GSI is a profitable business that manufactures and sells paraphernalia with Greek symbols to fraternities and sororities.

The Board of Directors of GSI consists of Mary, Sam, and Harry. GSI issued and has outstanding 10,000 shares. Mary owns 60% of the issued shares, Sam owns 3%, and various investors own the remaining issued shares, none owning more than 4% of the shares.

The corporation has three employees: Mary, who is chief executive officer, Paul, who is the plant manager, and John, who is GSI's product designer. Paul is paid a salary, and John is paid a salary plus an annual bonus of 10% of GSI's net sales. Paul is not a shareholder. However, three months ago, John purchased 1% of GSI's issued shares from another shareholder.

GSI had \$100,000 in its surplus account. Mary, who needs the money to finance her dream trip around the world, urged the Board of Directors to declare the entire \$100,000 as a dividend. The other directors, Sam and Harry, did not object.

Paul objected on the ground that the money would be better used to expand operations. John objected because he was concerned that paying out the entire surplus account as a dividend might jeopardize payment of his bonus in future years. John and Paul demanded that Mary allow them to inspect GSI's business records. Mary refused.

At a properly noticed, duly called, and lawfully conducted meeting, the directors voted to pay the entire \$100,000 out as a dividend to be paid ratably to all shareholders. One week thereafter, Rufus bought 2% of GSI's shares and, at the urging of Paul and John, is contemplating filing a shareholder's derivative action to rescind the declaration of the dividend.

- 1. Did Paul and John have the right to inspect GSI's business records? Explain fully as to the rights of each.**
- 2. Was the dividend lawfully declared? Explain fully.**

**Does Rufus have the right to bring a shareholder's derivative action? Explain fully.**

## **Question 2 – Business Associations**

Many of the examinees who had difficulty with this question did not demonstrate an understanding of the following principles:

- A person is not an “interested director” simply because the person has an interest in spending money from a dividend.
- The business judgment rule is the benchmark for the conduct of a board of directors.

**QUESTION 11**

We Got Gas, Inc. (“Gas”) is a corporation legally formed under the Texas Business Corporations Act. Gas manufactures carbonated gas for the soft drink industry. Gas has 15 directors and 650 stockholders.

Historically, Gas has been the only carbonated gas producer in the U.S. that sells the gas in 200-pound bottles. Consequently, Gas has always maintained a substantial inventory of the large bottles.

Alan is the newly elected president of Gas, replacing Zeb, who was fired for cheating on his expense account. Ben is one of the directors.

Alan recently discovered that, while Zeb was still president, and without consulting with the Board of Directors, Zeb signed and delivered a properly worded deed to Owen, conveying a tract of land that Gas owned. Gas had purchased the land and was holding it for future development as a headquarters site. Owen paid Zeb for the land in good faith, and Zeb turned the proceeds over to Gas. Zeb signed the deed “Zeb, President of We Got Gas, Inc.” The deed was the only document Zeb delivered to Owen, and it is the only document ever prepared that refers in any way to the transaction.

Alan, in his capacity as president of Gas, and Ben, in his capacity as a director, visited Owen to examine the deed and discuss the transaction. During that visit, Owen became upset over Alan’s claim that the deed was not an effective conveyance of corporate real estate. Owen called the police and alleged that Alan and Ben had assaulted him. Alan and Ben hired lawyers and were subsequently tried for assault and acquitted of the charges. After their acquittal, Alan and Ben requested that Gas indemnify them for the attorney’s fees and expenses they incurred in their defense. Gas’s corporate treasurer refused.

Due to declining sales of the large 200-pound bottles of carbonated gas, the Board of Directors, at a lawfully called meeting, voted 14 to 1 to liquidate Gas’s entire inventory of the large gas bottles and to begin selling gas in smaller bottles only. The dissenting director objected to the decision on the ground that the sale of the entire inventory was unlawful without approval of the stockholders.

- 1. Do Alan and Ben each have the right to have the corporation indemnify them for the attorney’s fees and expenses they incurred in defending the assault charges? Explain fully.**
- 2. Was the delivery of only a deed by Zeb to Owen effective under the Texas Business Corporations Act to convey the land? Explain fully.**
- 3. Did the Board of Directors have the power to sell the inventory of large gas bottles without approval of the stockholders? Explain fully.**

### **Question 11 – Business Associations**

Only some of the examinees discussed the fact that the defense to the criminal case was *successful*. Successful defense is an element for both civil and *criminal* cases. *See* Art 2.02 - 1 H. The call of the question asked about the effectiveness of the conveyance under the *Texas Business Corporation Act*. Many examinees answered in terms of property law. *See* Art 5.08. The *business judgment rule* was not an appropriate answer regarding the sale of the gas bottles. Many examinees did not seem to understand that if a sale is in the *regular course of the business*, shareholder consent is not required. “Regular course of business” means that the corporation *continues to engage in the same business after the sale as before the sale*. *See* Art. 5.09.

February 2002

**QUESTION 12**

Abel, Bill, and Carl are individuals associated in two businesses, both legally formed in Texas.

One of the businesses is Castaway Confetti L.L.P. (“Castaway”), which manufactures confetti for tickertape parades. Abel, Bill, and Carl are each partners in the business.

The second business is Clean Sweep Limited (“Sweep”), which manufactures street cleaning equipment. In this business, Abel is the general partner; Bill and Carl are limited partners. Bill takes little interest in the day-today operation of the business, but Carl frequently consults with Abel about business operations.

Two lawsuits are pending against Castaway and each of its partners individually:

- ! One of Castaway’s suppliers is suing for collection of a past due debt. The size of the debt is more than the available assets of Castaway.
  
- ! A plaintiff is suing for a tort committed by Bill in the course and scope of business for Castaway. Neither Abel nor Carl was directly involved in the activity that led to the tort, nor did either of them have notice of the tortious activity until after it occurred. The insurance coverage for Castaway appears to be less than the expected recovery for this tort.

There are also two lawsuits pending against Sweep and each of its partners individually:

- ! One of Sweep’s suppliers is suing for collection of a past due debt. The size of the debt is more than the available assets of Sweep.
  
- ! A plaintiff is suing for a tort committed by Bill in the course and scope of business for Sweep. Neither Abel nor Carl was directly involved in the activity that led to the tort, nor did either of them have notice of the tortious activity until after it occurred. The insurance coverage for Sweep appears to be less than the expected recovery for this tort.

**Are Able or Bill or Carl *personally* liable for:**

- 1. The debt owed to Castaway’s supplier? Explain fully.**
- 2. The tort for which Castaway is being sued? Explain fully.**
- 3. The debt owed to Sweep’s supplier? Explain fully.**
- 4. The tort for which Sweep is being sued? Explain fully.**

## **Question 12 – Business Associations**

Many examinees did not demonstrate an understanding of the difference between a limited liability partnership and limited partnership. These are two **different** business forms. In the same vein, examinees seemed confused about the differences between limited partners in a limited partnership and general partners in a limited partnership. Many examinees also seemed confused about the concepts of how a partnership limits the liability of individuals as opposed to how a corporation limits the liability of individuals. For example, there were discussions about “piercing the partnership veil”.

July 2002

**QUESTION 3**

KemJen is an ordinary Texas business corporation. It has a three member Board of Directors. Its bylaws state that an annual meeting of the shareholders shall be held at the principal office of KemJen on the first Monday in January of each year, at which time the shareholders, by majority vote, shall elect a new director for a three-year term.

Prior to the January 2002 annual meeting, Pres, president and a director of KemJen, successfully solicited the written proxies of the shareholders holding 80% of the corporation's shares. The proxies did not recite whether they were revocable or irrevocable.

Seven shareholders, who cumulatively held 60% of KemJen's outstanding shares, were among those who had given their written proxies to Pres. Shortly before the meeting they learned that Pres intended to lobby the Board of Directors to sell substantially all of KemJen's assets to a company owned by Pres. These seven shareholders opposed the proposed sale. They agreed among themselves in writing to attend the annual meeting and vote as a block to elect a new director who would agree to fire Pres.

Shortly before the scheduled January 2002 meeting, Pres and one of the other Directors spoke in a telephone conference and agreed to reschedule the annual meeting to the first Monday in February. No notice of the rescheduled meeting was sent to the shareholders.

However, all shareholders learned of the change in date and attended the rescheduled meeting. The seven dissenting shareholders who had agreed to vote as a block announced that they revoked their proxies and were voting their own shares at the meeting. Pres ruled that the seven shareholders were out of order and refused to count their votes. Pres voted all 80% of the shares for which he had obtained written proxies and purported to elect a director of his choice. The newly elected board member and Pres then voted to sell substantially all of KemJen's assets to the company owned by Pres.

1. (a) Was the rescheduling of the annual meeting proper under Texas law? Explain fully.  
(b) Can the seven dissenting shareholders successfully object to the rescheduled meeting they attended? Explain fully.
2. Did the seven dissenting shareholders have the legal right to revoke their proxies? Explain fully.
3. What are the grounds, if any, upon which the seven dissenting shareholders can challenge the vote of the directors to sell substantially all of KemJen's assets to the company owned by Pres? Explain fully.

### **Question 3 – Business Associations**

Many examinees did not fully discuss why the rescheduling of the meeting was proper or improper. Most raised an issue of notice, but others did not discuss one or more of the potential issues as to whether the notice and holding of the telephone conference was proper, whether a quorum was present, or the potential effect that the by-laws could have on the issues. Many examinees seemingly overlooked the duty of care owed by the Board and did not fully discuss the impact of the interested director or how to handle that issue. Also, many did not adequately discuss whether the sale of assets was in the “usual and regular course of business” under the corporation code and the effect it would have.

July 2002

**QUESTION 4**

Dan and Courtney entered into an agreement to associate and jointly carry on a farming operation for profit in the name of Big Farm. Their written agreement contained the following provisions:

- It expressly stated that, “This agreement does not create a partnership between the parties;”
- Dan and Courtney would each contribute \$500 to the operation;
- They would share equally in the profits and losses; and
- Each of them would have the equal right to control and manage the operation.

Dan contributed his \$500 and spent most of his time working on Big Farm. Courtney has not yet contributed her \$500, and she spent no time working on the farm.

Dan sold farm products grown on Big Farm to Customer and received a check payable to Big Farm. He indorsed the check “Big Farm/Dan,” and received cash from the bank. Figuring that he was entitled to a salary for the work he did on the farm and that the amount just about covered the value of his personal services, he deposited the money in his personal checking account.

Courtney insists that she is entitled to one-half of the amount, after expenses.

- 1. What is the legal nature of the business association, if any, entered into between Dan and Courtney? Explain fully.**

For purposes of answering questions 2 and 3, assume that Dan and Courtney formed a Texas general partnership.

- 2. Was Dan entitled to (a) cash the check received from Customer and (b) retain any of the proceeds as compensation for his services? Explain fully.**
- 3. Is Courtney entitled to any of the money received from Customer? Explain fully.**

#### **Question 4 – Business Associations**

A number of answers did not adequately address the statutory rules for determining when a partnership is created. Many of the less successful answers lacked analysis of the legal nature of the enterprise from the document as well as the acts of the parties. Others did not seem to understand a partner's authority to do acts in the ordinary course of partnership business or the partner's rights, or lack thereof, regarding compensation for services performed.

February 2003

**QUESTION 5**

Cole, Inc. is a properly incorporated Texas business corporation. The elected directors are Abby, Dan, Jen, and Madisen. Cole, Inc.'s Articles of Incorporation authorized the issuance of 460 shares, but only 400 shares were in the original offering and actually issued. Abby, Dan, Jen, and Madisen each own 100 shares. Cole, Inc.'s bylaws provide that a majority of the elected directors constitute a quorum.

Due and proper notice of a meeting of the directors in accordance with the bylaws was sent to and received by the directors. The notice contained a statement of the business to be conducted at the meeting, including business relating to the sale of stock and issuance of dividends or distribution of surplus. At the time, Cole, Inc. had a surplus of \$15,000.

Abby, Dan, and Jen attended the meeting. Madisen was absent. The following business was conducted during the meeting:

- (a) Abby, Dan, and Jen voted that the corporation issue and sell to each of them 20 of the 60 unissued shares.
- (b) Abby and Dan voted to have the corporation loan them each \$10,000 to pay the tuition for business courses at the local junior college on the ground that taking the courses would help them do a better job as corporate directors. Jen voted against making the loan.
- (c) Abby made, and Dan seconded, a motion that the corporation make a distribution of \$40 per share to each shareholder.

Cole, Inc.'s Articles of Incorporation and bylaws contain no provisions regarding these matters, and no additional information or opinions have been provided to the directors.

Before the vote was taken, Jen became concerned about the motion to make a distribution and the way the meeting was going. Due to her concern, a recess was called and Jen contacted you for advice on the following questions:

- 1. Does Madisen have a right to acquire any of the 60 unissued shares, and, if so, what must she do to perfect that right? Explain fully.**
- 2. Can the corporation lawfully make the loans to Abby and Dan? Explain fully.**
- 3. Is the proposed \$40 per share distribution legal, and, if not legal but nonetheless approved, will Jen, as a director, have any personal liability and to whom? Explain fully, omitting any discussion of the availability of a shareholder derivative suit.**
- 4. Can Jen prevent passage of the motion to make the distribution by not returning to the meeting before the vote is taken? Explain fully.**
- 5. What should Jen do, if anything, to protect herself from liability if the motion to make the distribution passes? Explain fully.**

### **Question 5 – Business Associations**

Overall, most examinees did very well on this question. Many examinees did not fully analyze (or include an analysis in their answers) as to: (a) the right of Madisen to enforce her preemptive rights in stock by bringing an action, if necessary, within a prescribed period of time; (b) the legal rights of the corporation to make a loan to directors under certain conditions (not withstanding the \$10,000 amount); and (c) occasionally failing to distinguish between directors and shareholders.

**QUESTION 6**

Wyatt and Nicole want to invest in a used equipment business in Texas, and they want to limit their risk of loss to the \$50,000 they each intend to contribute to the venture. They intend to proceed as follows:

- They want to form Texas Equipment Exchange (“TEX”), a Texas limited partnership, in which each of them will be named as limited partners;
- Nicole plans to work as an employee of TEX and participate in the day-to-day management and control of TEX;
- They want to form a general Texas Business Corporation, the purpose of which will be to serve as general partner of TEX;
- The corporation will be called “Bank of Bargains” and have \$1,000 of authorized capital;
- Wyatt and Nicole will own the shares of the corporation equally;
- Wyatt will be President and Chairman of the Board of Directors of the corporation;
- Wyatt, as President and Chairman of the Board of the general partner corporation, will sign TEX’s promissory note to Lender to secure funds loaned to TEX for the limited partnership operations.

1. **Can Wyatt and Nicole lawfully form a Texas business corporation for the purpose of serving as general partner of TEX and name it “Bank of Bargains? Explain fully.**
2. **Assuming that Wyatt and Nicole can properly incorporate the corporation and proceed with the plans outlined above, as to each of the following explain fully whether they may be liable to Lender for any money borrowed by TEX:**
  - (a) **The corporation?**
  - (b) **Wyatt?**
  - (c) **Nicole?**

## **Question 6 – Business Associations**

The examinees generally did a good job in answering this question. A significant number of the examinees, however, did not demonstrate a good understanding of the legal status and powers of a Texas corporation. A number of those examinees analyzed the problem of trying to avoid partnership liability by having a corporation serve as a general partner on an equitable basis rather than legal basis. A number of examinees did not do a good job of recognizing or explaining the legal protections or exemptions from liability provided to an officer, director, limited partner, or shareholder. A significant number of examinees misread or otherwise confused the facts of the problem and answered questions that were not asked.

July 2003

**QUESTION 3**

For the past two years, Jenny and Courtney operated a home repair business in Texas. It was a partnership called Specialty Business Company. An assumed name certificate was properly filed reciting that Specialty Business Company was a partnership between them.

In January 2002, they decided to incorporate the business as a Texas business corporation. They submitted the necessary fees and proper Articles of Incorporation to the Secretary of State to incorporate the business under the name of Specialty Business Company, the same as the partnership, reciting that Jenny and Courtney would be the sole shareholders and the initial officers and directors. Jenny and Courtney realized that the corporation would be undercapitalized, but they did not want to put any additional money at risk.

In February 2002, before the Secretary of State approved the Articles of Incorporation, Jenny purchased supplies from Melissa on credit in the name of Specialty Business Company. She duly disclosed that she was acting in a representative capacity as an agent for Specialty Business Company, intending the purchase to be an obligation of the corporation. Melissa shipped the supplies and billed Specialty Business Company for the money due.

In March 2002, Jenny and Courtney received from the Secretary of State the properly filed and approved Articles of Incorporation. They immediately called a corporation organizational meeting, adopted bylaws, elected Courtney as president and Jenny as vice president, issued shares to Jenny and Courtney, set up corporate books and records, and officially dissolved the partnership.

In April 2002, Courtney purchased an expensive paint spraying system from Karl on credit. She properly disclosed that she was acting as an officer and agent of Specialty Business Company, and she signed the purchase documents "Specialty Business Company, by Courtney, President."

By June 2002, Specialty Business Company had suffered business reverses and could not pay its bills, including the outstanding bill from Melissa and the balance owed to Karl.

Melissa and Karl each sue Specialty Business Company, Jenny, and Courtney for breach of contract.

- 1. Which entities and individuals, if any, are liable to Melissa? Explain fully.**
- 2. Which entities and individuals, if any, are liable to Karl? Explain fully.**
- 3. After the incorporation, what are the consequences if Jenny and Courtney fail to take appropriate action with regard to the assumed name certificate? Explain fully.**

### **Question 3 – Business Associations.**

Some examinees may not have read the question carefully and missed relevant dates as a result. A number of examinees indicated some confusion over de jure and de facto corporations. Many applicants were not familiar with assumed name certification and its impact, nor with the need to publish notice whenever an existing business becomes incorporated.

July 2003

**QUESTION 4**

Ashley and Elizabeth form an entity called Partnership, a properly formed Texas general partnership. They agree to exert their best efforts to make Partnership profitable and that they will each contribute the following capital: Ashley contributes \$5,000 in cash; Elizabeth contributes a computer worth \$2,500 and commits to contribute \$2,500 in cash within a few days. However, Elizabeth never makes the \$2,500 cash contribution.

Ashley, without discussing with Elizabeth her intent to do so, borrows \$10,000 from Bank. She borrows the money in the name of Partnership for use in the general course of Partnership's business.

Ashley calls on Wyatt, a customer of Partnership, and fraudulently obtains \$3,000 as a deposit on goods to be furnished to Wyatt by Partnership. Ashley misappropriates the \$3,000 for her own use, and Partnership does not deliver the goods to Wyatt.

While driving her personal car on the way to meet with a potential Partnership customer, Ashley negligently collides with Madisen's car. She causes \$15,000 damage to Madisen's car, but has no insurance coverage.

Elizabeth finally gets fed up with Ashley's conduct and gives the required legal notice that she is withdrawing from Partnership. However, she refuses to participate in winding up Partnership and the costs associated therewith. Ashley has left town, and her whereabouts are unknown.

**Assuming Partnership has no assets, does Elizabeth have any obligation or liability to:**

- (a) Partnership? Explain fully.**
- (b) Bank? Explain fully.**
- (c) Wyatt? Explain fully.**
- (d) Madisen? Explain fully.**

**Question 4 – Business Associations.**

A significant number of examinees did not adequately cover the joint and several liabilities of general partners for the indebtedness incurred by another partner in the ordinary course of business, other liabilities of a general partner, or the limitation on a partnership creditor's pursuit of a partner's property. A number of examinees wrote about the liabilities incurred by Elizabeth on an emotional or equitable basis rather than a legal basis, and some did not carefully read the facts and questions asked.

February 2004

**QUESTION 9**

Liz, Inc., a Texas corporation, was incorporated in January 2000, under the *Texas Business Corporation Act* to carry on an automobile painting business. Kim is the president and owns 80% of the stock of Liz, Inc. Ashley owns the other 20% of the Liz, Inc. stock. Kim and Ashley have been the sole directors of Liz, Inc. at all times. Kim is the only one of the two who is active in the business. Kim started the business with \$5,000 in the bank, but has less than \$1,000 in assets now. Ashley knows nothing about the financial condition of the company or its debts, and no board of directors meetings were held in 2003.

In the regular course of business, Kim as President, made purchases of painting supplies on credit from Courtney as follow: (1) on July 1, 2003, she purchased \$5,000 worth, with payment due on July 31, 2003; and (2) on August 10, 2003, she purchased \$1,000 worth, with payment due on August 31, 2003. No payments have been made on either purchase.

Kim knew at the time she placed both orders with Courtney that the liabilities of Liz, Inc., exceeded its assets and the corporation did not have the cash to pay the current bills, but Kim did not reveal this to Courtney.

The corporate records also reflect that Kim had failed to pay the franchise taxes due on the corporation and that Liz, Inc.'s, right to do business in Texas had been forfeited on July 31, 2003.

**What liability, if any, do the following have for the unpaid amounts on each of the two purchases of the painting supplies:**

- (a) Liz, Inc.? Explain fully.**
- (b) Kim? Explain fully.**
- (c) Ashley? Explain fully.**

### **Question 9 – Business Associations.**

Some examinees did not adequately discuss the issues raised regarding authority of officers to bind a corporation on contracts. A number of examinees did not discuss accurately the liabilities to which officers and directors are exposed when the franchise taxes are not paid or the corporate shield is otherwise allowed to lapse. A number of examinees only dealt with Ashley as a shareholder, not as a director (a problem with reading the facts of the question). Other examinees shifted the entire burden on Kim for her acts as the active officer and director and basically exonerated Ashley as a shareholder and director from any potential responsibility without a legal analysis of the facts. Some examinees treated and defined Ashley as a limited partner because of her limited role. Some examinees wasted time discussing alter ego and piercing the corporate veil, despite instructions on the exam question to the contrary.

February 2004

**QUESTION 10**

Dan owns all rights to develop, manufacture and sell a new computer he believes will perform better and cost less than other computers of equal capacity. Dan has two wealthy friends, Wyatt and Mark, who are interested in investing in this business with him. Each would invest \$100,000, for a total of \$300,000. There may be a substantial risk of loss in this new business, and the investors do not want to risk their family fortunes in it. In setting up the business there are three principal objectives the investors want to accomplish:

- (1) To limit the liability of each investor to the \$100,000 that each contributed;
- (2) To give each investor assurance of an equal voice in the management and operation of the business without exposing them to personal liability beyond the amount of their investment; and
- (3) To ensure that the profit and loss resulting from the business can be reported as income or taken as a deduction directly on the individual federal income tax returns of the investors without being taxed first to the entity.

The investors wish to consider the following three forms of business entities:

- (a) Limited partnership;
- (b) Limited liability company; and
- (c) Texas business corporation.

**What are the relative advantages and disadvantages of each entity with respect to each of the investors' stated objectives, and which of the entities would you recommend that the investors choose? Explain fully.**

**Question 10 – Business Associations.**

Overall, examinees did a good job in answering Question 10. Some examinees tended to mix up the type of entities involved and wrote about LLPs or their members or partners rather than LLCs and their members or managers. Most examinees recognized the equal management problem with the limited partnership, but many examinees did not discuss how that problem might be mitigated by use of a corporation or LLC as the general partner, etc. (i.e., the question could have been answered a little more completely). Many examinees could have more fully explained the reasons for recommending the entity that they chose.

July 2004

**QUESTION 3**

Kim, as incorporator, signed and filed Articles of Incorporation (“Articles”) for DanCo, Inc., a Texas business corporation. Kim was the only director named in the Articles. The Secretary of State issued a certificate of incorporation in January 2003.

Three subscription agreements were attached to the Articles filed with the Secretary of State, wherein Nicole, Ashley, and Elizabeth each agreed separately to buy 100 shares of DanCo stock without par value for \$1,000.

In February 2003, while out of state and without sending notice to anyone, Kim held an organizational meeting, adopted bylaws, and, in accordance with those bylaws, elected herself president and secretary of the corporation. Kim owned no DanCo stock, and she had not collected any funds in payment for stock from anyone. Kim was the only person in attendance at the organizational meeting. She kept no minutes of the meeting.

Kim, as Director, took the following actions after the organizational meeting:

- She issued a stock certificate for 100 shares to Ashley in return for Ashley’s transfer to DanCo of a \$1,000 bank certificate of deposit maturing one year later;
- She issued a stock certificate for 100 shares to Elizabeth in return for an agreement made by Elizabeth to perform \$1,200 worth of services for DanCo within the next two years;
- She cancelled Nicole’s subscription 120 days after the Articles were filed, and she refused to issue stock to Nicole. Kim took this action in good faith, believing it was in the corporation’s best interest. When asked about it by Ashley and Elizabeth, Kim slandered Nicole by stating that Nicole had a criminal record. In fact, Nicole had no criminal record.

Nicole has sued DanCo and Kim, individually, for breach of contract, slander, and a determination that DanCo does not exist because Kim did not properly elect officers and follow other corporate formalities.

- 1. Was the organizational meeting legally held, and were the necessary officers properly elected? Explain fully.**
- 2. Can Nicole’s attack on the corporate existence of DanCo succeed? Explain fully.**
- 3. Assuming the corporation DanCo legally exists, were the shares issued to (a) Ashley and (b) Elizabeth legally issued? Explain fully.**
- 4. Assuming the corporation DanCo legally exists, what potential liability, if any, does Kim personally have to Nicole? Explain fully.**

### **Question 3 - Business Associations**

Examinees did generally well on the first and second sections of Part 1. Some points were not picked up because the answer did not reflect recognition of some issues, i.e., organizational meeting held in or out of state, dual offices held by one person, etc. In the second section most examinees did well, but some made assumptions that were not in the facts, and did not adequately deal with the question of whether the corporate existence of the corporation could be successfully attacked. On the third section, a number of the answers did not reflect an understanding of the directors' ability under appropriate circumstances to issue stock for consideration other than cash. In the fourth section, some examinees did not adequately discuss the liability or lack thereof of an officer or director both as to a contract liability or a director's tort. Some points continue to be lost because of the failure to read the question carefully or by assuming facts not stated or by not making the assumption that a question expressly asked the examinee to assume. The importance of carefully reading the question cannot be overstated.

July 2004

**QUESTION 4**

Jenny Jones, Madisen Jones, and Wyatt Smith decided to form a Texas limited partnership and to call it Jones, Ltd. Each of them contributed \$25,000 to the partnership and agreed in writing to contribute an additional \$10,000 within a year. The Certificate of Limited Partnership was properly prepared and signed. Jenny was named as the general partner, and Madisen and Wyatt were named as the limited partners. However, because of an oversight by their attorney, the Certificate did not get properly filed. Believing that the Certificate had been properly filed, Jenny, Madisen, and Wyatt started doing business as Jones, Ltd.

Jenny and Wyatt worked as employees of Jones, Ltd. Madisen was not an employee. Jenny identified a building owned by Seller that she thought was desirable for use as the offices of Jones, Ltd. Wyatt inspected the building and found it suitable. Madisen then requested a partnership meeting. The meeting to discuss the building was attended by all three partners, and Madisen advised Jenny to buy the building.

Seller knew that Jenny, Madisen, and Wyatt were partners in Jones, Ltd. but had no particular knowledge or belief as to whether they were general or limited partners. Jenny told Seller that each of the partners was committed to contributing another \$10,000 to Jones, Ltd. within a year. Relying on the prospect of a later infusion of cash into the business, Seller agreed to sell the building to Jones, Ltd. on credit. Jenny gave Seller a promissory note to cover the purchase price. She signed the note "Jenny Jones, for Jones, Ltd."

After the purchase of the building, Jenny discovered that the Certificate had not been filed, and she caused it to be filed with the proper authorities.

Thereafter, Jones, Ltd. became insolvent. The partners voted to release each other from the obligation to make the additional \$10,000 contribution, ceased doing business, and defaulted on the promissory note.

**What liability, if any, does *each* of the following persons have to Seller on the note and on their agreements to contribute the additional \$10,000 capital?**

- 1. Jenny? Explain fully.**
- 2. Madisen? Explain fully.**
- 3. Wyatt? Explain fully.**

#### **Question 4 – Business Associations**

A number of examinees did not demonstrate a good understanding of the liability of a general partner and a limited partner in a limited partnership or partner in a general partnership for liabilities, such as notes executed under the facts stated. Some examinees failed to earn points available by discussing in more detail the reasons by the general partner would be liable under the facts stated. A number of examinees recognized the issue of control on potential liability but did not have a good feel as to the extent of safe harbors for limited partners, such as requesting meetings, advising general partners, etc. Many examinees did not discuss the potential exception to liability created by a good faith belief that a limited partnership had been formed. Over all, examinees did reasonably well, but careful reading of the question needs to be encouraged.

February 2005

**QUESTION 9**

In 1999, Dan and Wyatt properly formed a Texas limited partnership to practice law in Texas. Dan was designated the general partner, and Wyatt, the limited partner. The partners agreed to share all fees equally, after payment of expenses.

In 2000, Dan, after consulting with and receiving affirmative advice from Wyatt, signed as general partner of the limited partnership a ten-year lease for office space at the cost of \$10,000 per year.

In 2001, Dan, with Wyatt's consent, executed and filed an application for their firm to become a Texas registered limited liability partnership. The Texas Secretary of State approved the application in January 2002. Dan was designated as the managing partner, and the limited liability partnership thereafter complied with all formalities and legal requirements.

In December 2002, Dan awarded himself a small salary of \$500 per month to compensate himself for the extra work he does as managing partner. The partnership agreement is silent on salary compensation for the partners, and Dan did not consult Wyatt on this matter. To date, however, Dan has not paid any of the salary to himself.

In 2003, Dan hired Abby, a young attorney to work as an associate for the partnership under Dan's supervision and direction. In the course of performing work in which Dan was directly involved for a client named Madisen, Abby committed malpractice. The malpractice caused Madisen \$40,000 in damages. Wyatt first became aware of the malpractice after it occurred and too late to prevent or cure it.

Also in 2003, while consulting with a client named Courtney on regular firm business, Wyatt negligently dropped a printer on Courtney's foot. Courtney suffered injury and \$10,000 in damages.

The partnership has no assets and was dissolved in 2004.

- 1. Are Dan and Wyatt, or either of them, personally liable to**
  - (a) The landlord on the office lease? Explain fully.**
  - (b) Madisen for damages resulting from Abby's malpractice? Explain fully.**
  - (c) Courtney for damages resulting from the injury to her foot? Explain fully.**
  
- 2. Is Wyatt liable to Dan for the unpaid \$500 per month salary? Explain fully.**

### **Question 9 – Business Associations**

The examinees generally did a good job in answering the questions asked.

Some examinees misread or otherwise confused the facts, which may have caused some of the incorrect answers.

Many examinees continue to bypass a few points by not explaining their answers fully.

Some examinees failed to distinguish an LP from an LLP and continued to treat Dan as a GP in the LLP after it formed.

A number of examinees felt that changing the entity from an LP to an LLP would erase any liability on the lease from the general partner, even without an agreement from the landlord, while others continued to hold the former General Partner liable for acts occurring in the LLP.

Some examinees also felt that Dan legally deserved a salary absent any provision or agreement and held Wyatt liable.

**QUESTION 10**

Mad Corp is a Texas general business corporation. Elizabeth is Mad Corp's sole director.

In March 2002, Jen acquired 500 shares of Mad Corp stock, which then constituted 10% of Mad Corp's authorized and issued stock.

In January 2003, upon proper and timely notice given to all shareholders of record, a joint meeting of the shareholders and the director of Mad Corp was properly called to consider a resolution to issue and sell 5,000 shares of authorized but unissued no-par value shares of stock of the corporation. At the meeting, the resolution was adopted, and Elizabeth then announced that the 5,000 shares would be issued and sold within 30 days to a major customer of Mad Corp at a reasonable price determined by Elizabeth.

Jen asserted that Mad Corp was operating illegally by having just one director. Jen made a written demand that she: (1) be permitted to inspect the books and records for the purpose of gaining information necessary for her (Jen) to call a special shareholders meeting to vote on a resolution that would require the corporation to have at least two directors; and (2) be permitted to buy 10% of the newly issued shares. Mad Corp refused both of Jen's demands.

In March 2003, Jen bought a tract of land called Greenacres that was adjacent to Mad Corp's headquarters. Jen knew that Mad Corp had publicly indicated that it was interested in trying to buy Greenacres to expand its operations, but Jen bought the property anyway. Elizabeth asserted that the opportunity to purchase the property was a corporate opportunity that Jen, as a significant shareholder of Mad Corp, should have first offered to Mad Corp.

- 1. Does Jen have the right to acquire any of the newly issued 5000 shares of Mad Corp stock and, if so, what would she have to do to exercise that right? Explain fully.**
- 2. Does Jen have the right to inspect the books and records of Mad Corp? Explain fully.**
- 3. Was Mad Corp required to have more than one director, and, if not, does Jen have the right to call a special shareholders meeting to vote on a resolution to require more than one director? Explain fully.**
- 4. Did Jen owe any duty to Mad Corp to first offer Mad Corp the opportunity to acquire Greenacres before she personally bought Greenacres? Explain fully.**

### **Question 10 – Business Associations**

Some examinees were not careful to answer all subparts of a question.

The most consistent error made was that a Texas corporation is required to have more than one director.

Most examinees hit the major points that were looked for in the question and seemed to handle this question efficiently.

July 2005

**QUESTION 11**

Caster, Inc. (“Caster”) is a corporation incorporated in 2000 under the Texas Business Corporation Act. Caster is not a closely held corporation, nor is it subject to the Sarbanes-Oxley Act. Its principal business is buying interests in real property for resale.

Elizabeth, Caster’s president, was duly authorized by a resolution of the board of directors to purchase and sell real property on such terms as she deemed fair and appropriate.

In 2002-2004, Elizabeth, without consultation or further direction from the board of directors, took the following actions:

- (a) She sold all the real property Caster had in its inventory in order to pay the overhead and to continue in business;
- (b) She authorized a loan of \$20,000 from the corporation at a reasonable interest rate and repayment terms to one of the three directors to be used to pay that director’s tuition for an intensive course of study in real estate marketing;
- (c) To raise additional money to purchase real property for resale, Elizabeth created and issued an option to purchase 25,000 unissued shares of Caster’s common stock, and sold the stock to Madisen, an outsider, who paid fair market value for it; and
- (d) She sold the building owned and used by Caster as its offices and headquarters, which was the sole remaining corporate asset.

**Did Elizabeth have the authority to take these actions, and, as to each action, why or why not? Explain fully.**

### **Question 11 – Business Associations**

A significant number of examinees misread some of the facts of the problem, so all examinees need to continue to be encouraged to read the question carefully and provide legal advice as to the legal issues raised in the question. Some examinees could have explained in more detail the existence under which corporate loans are appropriate. Other applicants failed to discuss the potential interested director issue. Most examinees recognized the general authority of the Board as to issuing or valuing stock, but others did not respond to the potential problem involving preemptive rights of the shareholders in the sale of stock to an outsider. Some examinees wrote about the sale of the corporate headquarters primarily as a business judgment problem, i.e., questioning the president's judgment as a business person, rather than from a legal standpoint under the facts.

July 2005

**QUESTION 12**

In January 2004, Abigail and Courtney, interior decorators, purchased a small shopping center as tenants in common, each contributing half the money to pay for and maintain the shopping center. They agreed to share equally in the gross rental receipts. They shared a small office in one corner of the shopping center from which they independently conducted their interior decorating businesses.

In February 2004, Abigail, while doing some shopping center maintenance, negligently damaged property belonging to Kim, one of the shopping center tenants.

In March 2004, Abigail and Courtney associated to jointly carry on an interior decorating business under the name of AC Décor. They agreed to contribute equal amounts of start-up capital and to share equally in the control and in all profits of the business, and to share equally all profits of AC Décor. They did not agree to share any losses they might incur in the business.

In May 2004, Abigail failed to timely complete a decorating job for Nicole, a customer of AC Décor. This delay caused Nicole's business to sustain a loss of sales.

In June 2004, with the consent of both Abigail and Courtney, Dan paid them 1/3 of the amount they had contributed as start up capital, and became an equal owner of AC Décor.

In August 2004, Abigail, Courtney and Dan properly formed a limited liability company and thereafter conducted an interior decorating business as CAD, LLC. Abigail, Courtney, and Dan were each members of CAD, LLC, and Abigail was named as manager.

In September 2004, Abigail, in her capacity as manager, purchased in the name of CAD, LLC a paint sprayer on credit from Jennifer for use by CAD, LLC.

In October 2004, Abigail contracted with CAD, LLC to pay herself as manager a salary of \$500 per month for extra work she does. The \$500 was fair compensation for the amount of work involved.

The claims of Kim and Nicole and the debt to Jennifer remain unpaid.

- 1. What liability, if any, do Abigail, Courtney, Dan, and CAD, LLC each have for:**
  - a. The damage to Kim's property? Explain fully.**
  - b. Nicole's loss of sales? Explain fully.**
  - c. The unpaid debt to Jennifer? Explain fully.**
  
- 2. Did Abigail have authority to pay herself a salary for the extra work she did as manager? Explain fully.**

## **Question 12 -- Business Associations**

Many examinees did not fully identify the factor generally indicating a partnership or that Abigail and Courtney owned the shopping center together as tenants-in-common, which does not indicate that the co-tenants were partners. A significant number of examinees failed to carefully answer the question of liability for debts obligations presented as to each of the entities involved. Likewise, a number of the examinees did not adequately identify the duty and authority of a manager of an LLC and their ability to contract.

Generally, examinees did well. Everyone still needs to read each question carefully and answer fully.

February 2006

**QUESTION 1**

In 2003, Cole and Kim were engaged in the practice of law in a general partnership named Cole & Kim in Waco, Texas. The partnership owed \$50,000 to Texas Bank.

In November 2004, Ashley, a prominent and wealthy local lawyer, joined Cole & Kim and became a general partner.

In December 2004, Cole, as a general partner, bought \$30,000 worth of office equipment in the ordinary course of business for the general partnership. This was bought on credit from Office Store without discussing it in advance with any of the partners.

In January 2005, Ashley borrowed \$6,000 for personal purposes and signed a security agreement with Friendly Bank to give the bank a security interest in Ashley's one-third interest in the general partnership's equipment.

In February 2005, Kim, without Cole's and Ashley's knowledge or consent, sold some shares of stock belonging to a client without the client's consent. This resulted in a loss of \$7,000 to the client.

In March 2005 Ashley, persuaded Kim and Cole to dissolve the general partnership and form a limited partnership and insisted that it be named "Ashley, Kim & Cole, L. P." Ashley and Cole were limited partners and Kim was named as the general partner.

In April 2005, Kim, as general partner and after consulting with and obtaining the approval of Ashley and Cole, borrowed \$80,000 from Owner to purchase Owner's building.

The foregoing debts all remain unpaid. Ashley, Cole & Kim, L.P. is now insolvent. Cole and Kim have no property outside of the partnership.

- 1. What are Ashley's liabilities, if any,**
  - a. To Texas Bank for the \$50,000 owed by Cole & Kim in 2003? Explain fully.**
  - b. To Office Store for the \$30,000 purchase of equipment by the general partnership in December 2004? Explain fully.**
  - c. To the client for \$7,000 for the wrongful sale of stock by Kim in February 2005 without the other partners' knowledge or consent? Explain fully.**
  - d. To Owner for the \$80,000 purchase of the building in April 2005 by the limited partnership? Explain fully.**
  
- 2. Was the security agreement signed by Ashley effective to give Friendly Bank a security interest in a one-third undivided interest in the office equipment purchased by the limited partnership? Explain fully.**

## **Question 1 - Business Associations**

1(b) Ashley's liabilities to Office Store – The most common error on this subsection was the lack of discussion on Cole's authority, either actual or apparent, to purchase furniture on behalf of the partnership.

1(c) Ashley's liability to Client – A mistake in this subsection occurred when some examinees applied the rules for other kinds of partnerships when discussing the liabilities that general partners face with regard to the torts and malpractice committed by other general partners.

1(d) Ashley's liability to Owner – A common mistake on this subsection was just answering that Ashley was not liable as a limited partner and ending the answer at that with no discussion of the circumstances present where individual liability could attach to the limited partner.

2 Validity of Security Agreement – A common error of those who did not fully answer the question was in failing to recognize that the partner was attempting to give a security interest in specific partnership property to secure a personal loan and in failing to discuss the nature of a partner's rights in specific partnership property.

February 2006

**QUESTION 2**

AbbyCourt Company was a Texas business corporation that sold tennis equipment. Jennifer, Dan and BJ served as the directors. In addition to these directors, there were 10 other shareholders.

In 2004, the directors gave notice by e-mail to all shareholders that the directors intended to hold a Board of Directors meeting to consider a resolution (1) disposing of all AbbyCourt's property by sale not in the regular course of business and on such terms and conditions as the Board of Directors approved and (2) adopting Articles of Conversion converting AbbyCourt from a Texas business corporation to a Texas registered limited liability partnership ("LLP").

Two of the directors, Jennifer and Dan, were not present at the meeting, but had given written proxies to BJ to vote in their stead for the proposed resolution.

The meeting went forward and, justifying the decision in part on a memorandum from AbbyCourt's corporate legal counsel opining that the tax treatment of LLPs was more favorable generally than the tax treatments of corporations, BJ cast three votes in favor of the resolution. The minutes of the meeting reflected that the resolution had been adopted and that the directors were going to proceed to sell the property and convert to an LLP.

The other 10 shareholders object to the action taken by the Board of Directors and seek to have it declared invalid.

- 1. What grounds, if any, do the shareholders have for objecting to the way the Board called the meeting and the action taken by the Board? Explain fully.**
- 2. Assume that all proper steps have been taken to carry out the proposed sale of all of AbbyCourt's property, what rights, if any, do any dissenting shareholders have?**
- 3. Under state and federal tax laws, are there any tax advantages applicable to being organized as a Texas LLP as compared to being organized as a Texas business corporation? Explain fully.**

## **Question 2 - Business Associations**

An area of missed opportunity for part one of this question was in not carefully reading the question to note that it was a director's meeting that was called and discussing the requirements for giving notice of a director' meeting and for the board to take proper action on the proposed sale of assets and the proposed conversion. Many examinees did not fully answer each of the questions presented.

Likewise in part two the rights of dissenting shareholders were sometimes identified to exist but not fully explained.

In part three, most examinees discussed "double" federal taxation on corporate income but many did not mention the potential impact of state franchise taxes or other fees charged by the state.

In summary, most examinees did fairly well; however, reading the question carefully, understanding and answering the question(s) asked, and then explaining the answer fully (to the extent time permits) remain very important.

July 2006

**QUESTION 3**

In 2002, Bear, Ella, and Astro organized and incorporated Bear Bank Company (“BBC”) under the Texas Business Corporations Act to sell sports memorabilia. The reason for calling it Bear Bank Company was to capitalize on Bear’s name because he was a famous sports celebrity. Before adopting this name, the organizers did not make inquiry about the legality or availability of the name.

The Articles of Incorporation: (1) specified that BBC’s sole business was the sale of sports memorabilia; (2) named Bear, Ella, and Astro as the initial directors; and (3) authorized the issuance of 1,500 shares of \$5 par value common stock. After receiving advice from an experienced stockbroker employed by BBC that it would be proper to do so, the directors voted to sell 500 shares each to the three employees of BBC: Courtney, Dan, and Wyatt. The shares were issued to Courtney in consideration of the services she had performed in organizing the corporation. Dan paid \$3,000 cash for the shares issued to him. The shares issued to Wyatt were in consideration of services to be performed by him under a written contract with the corporation.

In 2003, Bear bought Dan’s 500 shares for \$2,500, the then fair market value. In 2004, before his term on the board of directors expired, Bear, a Texas resident, died intestate, survived by his wife and only heir, Mary. Mary claimed that the 500 shares were community property and that, as Bear’s successor and current owner of the shares, she has the right to be appointed to succeed to Bear’s seat on the BBC board of directors.

The two surviving directors mutually agreed that directors’ meetings could be called on the basis of notice given electronically, i.e., by e-mail. The directors gave electronic notice of a directors’ meeting and, by unanimous vote and over objection by Mary, elected Julia, Wyatt’s wife, to fill the vacancy on the board.

- 1. What procedures, if any, should the organizers of BBC have taken to determine the legality of adopting Bear Bank Company as the name of the corporation and was the selection of the name Bear Bank Company a legally permissible name? Explain fully.**
- 2. Did the directors act lawfully in authorizing and pricing the BBC shares and in issuing them to Courtney, Dan, and Wyatt for the consideration received from each of them? Explain fully.**
- 3. What rights did Mary’s sole ownership of the shares confer on her regarding the right to succeed Bear on the board of directors? Explain fully.**
- 4. Was the election of Julia as a director properly conducted by the remaining board members? Explain fully.**

### **Question 3 - Business Associations**

In section 1, most applicants identified the need to check the name availability through a search with the Secretary of State or otherwise; fewer mentioned the advantage of using the reservation of corporate name procedure. The majority recognized most of the corporate name issues.

In section 2, a number of examinees jumped to the theory of preemptive rights and did not continue with the analysis of the actual issuance and whether or not it had been done correctly. Many examinees also did not address the Board of Directors' ability to rely on experts and their judgment being protected.

In section 4 many examinees correctly noted that stockholders elect directors but did not consider the possibility of the Board of Directors being able to fill a vacancy under proper circumstances. Many discussed the quorum and notice requirements, but it often was as to the shareholders and not the Board.

July 2006

**QUESTION 4**

Kim, Cole, and Madisen legally and properly created a limited partnership called BowWowMeow, Ltd. (“BWM”) to operate a pet shop. Kim was the general partner. Cole and Madisen were limited partners and did not involve themselves in the day-to-day management of the business.

In 2002, Kim, without discussing it with Cole and Madisen, contracted with Ashley for the purchase of \$1,000 worth of pet food to feed the animals in BWM’s shop. Kim signed the contract “BowWowMeow, Ltd. by Kim,” and Ashley delivered the pet food. BWM did not then have \$1,000 and has never paid Ashley. Ashley filed suit against BWM, Kim, Cole, and Madisen for the \$1,000 debt.

In 2003, Madisen withdrew from BWM as a limited partner, and BWM lawfully admitted Elizabeth as a new limited partner. At that time, Ashley amended her complaint to add Elizabeth as a defendant.

In 2004, BWM properly registered and complied with the applicable requirements of the Texas Revised Partnership Act to become a registered limited liability partnership and adopted the name KCE Ltd., LLP (“KCE”). Kim was the general partner, and Cole and Elizabeth were limited partners of KCE. At that time, Ashley further amended her complaint to add KCE as a defendant.

In 2005, Elizabeth, while working alone in the pet shop, negligently allowed a dog that had bitten several customers on prior occasions to run loose in the store. The dog bit and injured Jen, a customer who was in the store to buy pet supplies. Jen sued KCE, Kim, Cole, and Elizabeth for negligence and damages.

- 1. What is the liability, if any, of each of the defendants in Ashley’s lawsuit (BWM, Kim, Cole, Madisen, Elizabeth, and KCE) for the \$1,000 pet food debt? Explain fully.**
- 2. What is the liability, if any, of each of the defendants (KCE, Kim, Cole, and Elizabeth) to Jen for her injuries? Explain fully.**

#### **Question 4 - Business Associations**

In section 1 a common omission by many was in failing to fully explain the actual and apparent authority of a general partner acting in the ordinary course of business to bind the partnership and the general partner's liability for the debts of the partnership.

There were more than a few people who did not address the question of the new LLP's liability for the existing debt.

On section 2 most examinees understood the increased protection provided partners by the LLP, but there were a number of examinees who still felt the general partner had some liability, and there were more who failed to mention the exception to non-liability if a partner "supervised" or "had notice or knowledge" and failed to take action to prevent the injury.

Overall most examinees did well on questions 3 and 4. Full but brief disclosures of reasons (pro or con) for answers might benefit some.