2)

1. On what theory or theories might Arnold (A) be found personally liable for damages to Landlord Co.?

Promoter Liability

A promoter is someone who acts on behalf of a corporation prior to its incorporation. A promoter is personally liable for any pre-incorporation contracts entered on behalf of a corporation prior to its incorporation unless 1) there has been a novation to replace the promoter's liability with that of the corporation or 2) the parties have contracted out of promoter liability. Here, A is a promoter since he acted on behalf of Durable Paint, Inc. (Durable) prior to its incorporation, when he entered into a one-year lease with Landlord Co. (Landlord). Since there is no evidence to suggest that there was a novation or agreement between the parties, A remains personally liable to Landlord as a promoter.

Pre-Incorporation Contract Liability

A corporation is not liable for contracts entered into by a promoter unless the corporation adopts the contract. A corporation adopts a contract when it accepts the benefits of the contract. However, a corporation's adoption of a contract does not relieve the promoter from being held personally liable. In such a case, the promoter will remain personally liable but can sue the corporation for reimbursement. Here, A will argue that Durable is liable since it accepted the benefit of the lease by operating its business in the building owned by Landlord. However, even if Durable accepted the benefit of the lease, A will nonetheless remain personally liable for the lease since a corporation's adoption of a contract does not relieve the promoter of personal liability.

2. On what theory or theories might Betty (B) be found personally liable for damages to Landlord?

Piercing the Corporate Veil

Generally, shareholders are not personally liable for the debts and obligations of the corporation. However, the court will pierce the corporate veil to hold a shareholder liable when the: 1) corporation is the alter ego of the shareholder 2) corporation failed to follow corporate formalities 3) corporation was inadequately funded at its inception to cover prospective debts and liabilities or 4) to prevent fraud or injustice.

Inadequate Funding

A court will pierce the corporate veil when a corporation was inadequately funded at its inception to cover prospective debts and obligations. Here, Durable exhausted all of its capital within 6 months of business. The fact that Durable was behind on two months worth of rent by the end of the six months strongly suggests that it was inadequately funds at its inception to cover prospective debts and liabilities. In addition, A contributed his patent, worth less than $50,000, to Durable when he told B that it was worth $100,000. This further suggests that Durable was inadequately funded at its inception since it establishes that the business startup required about $200,000 rather than the $150,000 contributed. Therefore, the court can pierce Durable to hold B personally liable.

3. On what theory or theories might A be found personally liable for damages to B?

Direct Suit or Derivative Suit

A shareholder can bring a direct suit on their behalf to enforce a right owed to them. A shareholder can bring a derivative suit on behalf of the corporation enforce a duty owed to it, such as fiduciary duties. Here, the facts do not implicate that B's rights as a shareholder have been violated. However, A's conduct implicates his fiduciary duties to Durable. Therefore, B can bring a derivative suit on behalf of Durable.

Duty of Care

As fiduciaries of the corporation, directors and officers owe the corporation a duty of care and a duty of loyalty.

Business Judgment Rule

The business judgment rule is a presumption that directors and officers act 1) in good faith (on an informed basis) 2) with reasonable prudence and 3) with the reasonable belief that their actions are in the best interest of the corporation. Here, B will argue that A acted in bad faith because he did not act on an informed basis when he told her that he thought that his patent was worth $100,000 even though he was never offered more than $50,000 for it. In addition, reasonable director or officer under the circumstances would not defraud an investor. Thus, A cannot reasonably believe that his actions were in Durable's best interest.

Duty of Loyalty

Directors and officers must act in the corporation's best interest and refrain from 1) competing with the corporation 2) engaging in a conflict of interest transaction 3) trading inside information and 4) usurping a

corporate opportunity.

Conflict of Interest Transaction

A conflict of interest transaction is a transaction in which a director or officer personally benefits from. However, a director or officer can engage in a conflict of interest transaction 1) upon full disclosure and approval of disinterest board members and shareholders or 2) such transaction was fair to the corporation at the time it was entered into. Here, A engaged in a conflict of interest transaction when he lied to B that his patent was worth $100,000, rather than $50,000, in order to induce B's contribution to the business and to reduce his own contribution. A will argue that this transaction was fair to the corporation at the time it was entered into. However, B can show that the transaction was not fair to the corporation since Durable could not even last six months without exhausting all its capital. Therefore, A breached his duty of loyalty by engaging in a conflict of interest transaction.

Question #2 Final Word Count = 920

END OF EXAM