

Question 6

In 2011, Molly and Lenny started a computer software business. Molly prepared marketing materials and Lenny made sales calls. During the first year, Lenny sold 10 copies of certain software programs for \$50,000 each. The business had a net profit of \$480,000 and Molly and Lenny each received \$240,000.

In January 2012, Molly and Lenny hired an attorney to incorporate their business under the name "Software Inc." The attorney properly prepared all necessary documents to incorporate the business but carelessly failed to file them with the Secretary of State.

Lenny continued to make sales calls to sell the software. He also sold a five-year service contract developed by Molly. Due to brisk sales, Software Inc. projected income of about \$300,000 per year for the next five years from the service contracts alone. Software Inc. obtained a \$100,000 business loan from National Bank secured by the accounts receivable for the service contracts.

In May 2012, Lenny had an automobile accident, caused solely by his own negligence, on the way to visit a prospective buyer. The accident injured a pedestrian. As a result of the accident, Lenny stopped working and sales collapsed.

In July 2012, Software Inc. went out of business, leaving negligible assets and the unpaid loan to National Bank.

1. Is Software Inc., Molly, and/or Lenny liable to the pedestrian for the injury?
Discuss.
2. Is Software Inc., Molly, and/or Lenny liable to National Bank for the loan?
Discuss.

ANSWER A TO QUESTION 6

I. Liability to the Pedestrian

A. Lenny's Liability

This issue is whether Lenny is liable to the pedestrian for the automobile accident.

Generally, persons are liable for their own negligent conduct. While employers can be vicariously liable (discussed below) for an employee's tortious conduct, this liability is in addition to the employee's liability. However, if an employee was acting within the scope of their employment, to further the goals of the business, they could seek indemnification from the business.

Here, Lenny had an automobile accident, caused solely by his own negligence, on his way to visit a prospective buyer. The accident injured a pedestrian. Lenny will most likely be liable for the damages he caused. However, because he was on his way to visit a prospective buyer, Lenny could seek indemnification from Software Inc., because he was driving solely for the purpose of furthering Software's business by attracting a new buyer. In addition, his conduct was negligent, rather than intentional, which would prohibit indemnification. If, because of a failure to incorporate (as discussed below), Software Inc. is not actually a valid corporation, Lenny could still seek indemnification from the partnership between him and Molly, since he was still acting in furtherance of Software, the partnership (also discussed below). However, given Software's negligible assets, and its debt to National Bank, there may not be much to seek indemnification from.

Therefore, Lenny is liable to the pedestrian, but may be able to seek indemnification from Software, Inc.

B. Software Inc.'s, Vicarious Liability

This issue is whether Software Inc. is vicariously liable for Lenny's tortuous conduct.

A corporation/partnership/principal can be vicariously liable for the tortuous conduct of its agents if those agents act in furtherance of the principal, under the principal's control, and with the principal's express, implied, or apparent authority.

Here, Lenny had an automobile accident, caused solely by his own negligence, on the way to visit a prospective buyer. By driving to visit a buyer, it appears clear that Lenny was acting in furtherance of Software Inc. While Software Inc.'s corporation or partnership status will be discussed below, it is clear that Lenny was functioning as both a principal and as an agent. He was a principal in the sense that he was expressly authorized to make sales calls and presumably visit prospective buyers given that he started the computer software business and that he and Molly agreed to divide the work as such. He was an agent acting for the benefit of Software Inc. in driving to meet the buyer and further Software Inc.'s goals of collecting buyers.

Therefore, regardless of Software Inc.'s status, Software Inc. is probably vicariously liable for Lenny's tortuous conduct.

C. Molly's Liability

1. De Facto Corporation

This issue is whether Software Inc. had a de facto corporation status, such as to shield Molly from personal liability for Lenny's tortuous conduct.

A corporation is a unique organizational framework for a business, in which management is centralized, and shareholders enjoy limited liability. A corporation must file its articles of incorporation with the Secretary of Interior in order to be a valid corporation, and thus to enjoy this limited liability. However, a corporation that does not

file its articles of incorporation may nevertheless enjoy limited liability via de facto corporation. A de facto corporation 1) attempted to incorporate in good faith, 2) is otherwise eligible to incorporate, and 3) subsequently acted like a corporation in good faith.

In January 2012, Molly and Lenny hired an attorney to incorporate their business under the name "Software Inc." However, while the attorney properly prepared all necessary documents to incorporate the business, he carelessly failed to file them with the Secretary of State. It does not appear that Molly or Lenny knew that the attorney had failed to file the documents. Instead, Molly and Lenny continued to make sales and sell the software. In fact, they obtained a business loan from National Bank secured by its accounts receivable, thereby acting like a corporation in which corporation debts are secured by corporation profits. By hiring an attorney, and subsequently acting like a corporation, it appears that Molly and Lenny attempted to incorporate in good faith, and later acted as if they were a corporation in good faith, with no knowledge (or should have had the knowledge) that they were not actually a corporation. In addition, Software Inc. appears otherwise eligible to incorporate, but-for the failure to file the documents with the Secretary of State.

Therefore, it is possible that Molly will be shielded from liability if Software Inc. has de facto corporation status.

2. Piercing the Corporate Veil

This issue is whether Molly can be personally liable if the pedestrian pierces Software Inc.'s corporate veil.

Shareholders of a valid corporation may nevertheless be personally liable for corporation debts if the corporate veil is pierced. Courts allow a corporation's veil to be pierced when it is clear that there is such a commonality between the corporation and the shareholders, that the shareholders are actually the "alter ego" of the corporation,

and to not permit piercing would sanction a grave injustice. Failing to comply with corporate formalities and insufficient capitalization are common reasons courts have pierced a corporation's veil.

Here, if Software Inc. has de facto corporation status, Molly can be shielded from liability, unless Software Inc.'s corporate veil is pierced. There is no evidence that Molly and Lenny intentionally aimed for Software Inc. to act as their corporate alter ego. However, there is evidence that Software Inc. was severely under-capitalized. In 2011, Molly and Lenny made a net profit of \$480,000. However, instead of investing any of that profit back into the business, they instead each received \$240,000. In 2012, Software Inc. sold a five-year contract, and projected an income of \$300,000/year based just on service contracts. In addition it took out a \$100,000 loan. However, in July 2012, after Lenny stopped working for just two months, Software Inc. had only negligible assets AND its unpaid loan. It appears that either Molly and Lenny were taking dividends when the corporation could not pay its debts, or that Software Inc. was otherwise severely under-capitalized. Further, there are no facts to suggest that Molly and Lenny abided by any corporate formalities, such as holding a general meeting, issuing bylaws, or keeping accounting books. However, there is no information that they did not do these things either.

Therefore, it is possible that the pedestrian can pierce Software Inc.'s corporate veil and hold Molly personally liable.

3. General Partnership

This issue is whether if Software Inc. does not have a corporation status, they are instead a general partnership, and Molly can be held personally liable thereby.

A general partnership is a partnership between two or more people to go into business together. The formation of a general partnership only requires the intent to form a partnership. No documents need to be filed with the Secretary of State, unlike a limited partnership, a limited liability corporation, and a corporation. A general partnership only includes general partners who are personally liable for the debts and obligations of the partnership. The equal sharing of profits is presumptive evidence that parties intended to form a general partnership.

In 2011, Molly and Lenny started a computer software business. Molly prepared marketing materials and Lenny made sales calls. At the end of the year, the business had a net profit of \$480,000, and Molly and Lenny each received \$240,000. In 2012, Lenny and Molly continued to operate their software business in apparently the same way, with the same division of labor, as they had in 2011. They attempted to form a corporation, but their attorney negligently failed to properly file the forms. By sharing the profits equally in 2011, Molly and Lenny appeared to have presumptively formed a general partnership. In 2011, it appears that they operated as a general partnership, with an equal, but distinct division of labor. By sharing the profits, they implicitly agreed to also equally share the business's obligations, should there be any. When the attorney failed to incorporate Software, and assuming that Software is unsuccessful in obtaining de facto corporation status, Molly and Lenny continued to have a general partnership. It does not matter that they never formally agreed to form a partnership. Their sharing of the profits equally makes their relationship a general partnership until they agree otherwise. Thus, if Software Inc. does not have de facto status, Molly will be liable as a general partner. However, she will only be liable to the extent the business is without funds.

Therefore, Molly can be liable as a general partner.

II. Liability to National Bank

A. Software Inc.'s Liability for the Loan

This issue is whether Software Inc. is liable for the loan to National Bank.

Generally, corporations and partnerships are liable for the debts incurred during the normal course of business.

Here, National Bank issued a \$100,000 business loan to Software Inc., secured by Software Inc.'s accounts receivable. If Software Inc. has de facto status, then the loan was authorized by the corporation. If Software Inc. is a partnership, the loan was similarly taken during the course of business, for the purpose of the partnership, and was authorized by the partners. Regardless of Software Inc.'s status, the loan was received by Software, which subsequently enjoyed the benefits of the loan, and will thereby be held to have at least ratified the loan by accepting the loan.

Therefore, Software Inc. is liable for the loan, regardless of its status.

B. Lenny and Molly's Liability for the Loan

1. De Facto Corporation

This issue is whether Lenny and Molly can escape personal liability through de facto corporation.

This rule is discussed above, in section I.C.1.

Because Lenny and Molly made a good faith attempt to incorporate, and acted in good faith as if they were incorporated, they potentially could receive de facto corporation status, and thereby its included limited liability.

Therefore, Lenny and Molly could escape liability through de facto status.

2. Corporation by Estoppel

This issue is whether Lenny and Molly can escape personal liability through corporation by estoppel.

Even if a corporation fails to properly file its articles of incorporation with the Secretary of State, and even if a corporation fails to receive de facto corporation, a creditor may nevertheless be estopped from denying the existence of a corporation. If a creditor treated a corporation as such, and looked to corporate assets in making a loan, a corporation can be protected through corporation by estoppel.

Here, Software Inc. projected income of about \$300,000/year for the next five years from its service contracts. National Bank provided Software Inc. a \$100,000 business loan secured by the accounts receivable for the service contracts. National Bank believed Software, Inc. was a valid corporation. They could have done their due diligence to verify their corporation status. Further, National Bank only looked to Software Inc.'s assets, not Molly or Lenny's, in determining whether to issue the loan. Finally, they issued a business loan, underpinning National Bank's focus upon Software as a corporation. Because they treated Software as corporation in issuing the loan, they will be estopped from denying Software's corporation status in attempting to collect on the loan.

Therefore, Molly and Lenny could escape personal liability through corporation by estoppel.

3. Piercing the Corporation Veil

This issue is whether even if Software Inc. has de facto or corporation by estoppel, National Bank can go after Molly and Lenny personally by piercing the corporate veil.

This issue is discussed above, in section I.C.2.

Because Lenny and Molly failed to properly capitalize Software Inc., it is possible that National Bank could similarly seek to pierce Software's corporate veil.

Therefore, Molly and Lenny could be personally liable for the loan thru piercing the corporate veil.

4. Liable as General Partners

This issue is whether if there is corporate status, Lenny and Molly are liable as general partners.

This issue is discussed above in section I.C.3. General partners are personally liable for the remaining debts of the business.

Because Lenny and Molly originally functioned as a general partnership, if Software Inc. does not have corporate status, Lenny and Molly will be held to be general partners. Just as general partners get to share profits equally, they also must share the obligations equally.

Therefore, Molly and Lenny will each be liable for one half of the remaining obligation on the loan to National Bank.

ANSWER B TO QUESTION 6

Liability towards Injured Pedestrian:

Software Inc. v. Pedestrian

De Jure Corporation:

A de jure corporation is one that is properly formed. To form a de jure corporation the parties have to prepare the necessary documents required by the state for incorporation. Here, Molly and Lenny did not create a de jure corporation due to the fact that their attorney carelessly failed to file the documents. The fact that the corporation was not created does not mean that there are not other corporate like entities that could have arisen.

De Facto Corporation:

Molly and Lenny's strongest argument would be that they created a de facto corporation. A de facto corporation is where the parties take all the necessary steps to incorporate, but for some reason their attempt to incorporate was unsuccessful. If the parties have a good faith belief that a corporation was formed a court can find that a de facto corporation was created, which gives the parties all the same benefits and obligations that would arise under a normally created corporation. Based upon these facts a court would most likely find that a de facto corporation was created, Lenny and Molly took all the necessary steps to create a corporation and held themselves out to be a corporation and if it were not for the carelessness of their attorney in filing the paperwork they would be considered a corporation.

Liability of Shareholders in a De Facto Corporation:

Now that it is found that a de facto corporation was created we look to see if it is liable towards the pedestrian for the injuries suffered. The bonus of a corporation is that it protects its shareholders from liability, and therefore if a de facto corporation was formed Software Inc. might be liable for the injury, and possibly Lenny as it was caused by his negligence but Molly would be shielded from liability beyond what she had invested in the company.

Liability of a Corporation for Damages Caused by its Agents

A corporation can be liable for damages caused by its agents during the scope of their employment. In a corporation directors and officers are considered agents of the corporation and this is further demonstrated by the fact that they had the ability to bind Software Inc. to contracts and that they seemed to be the only two people working for the corporation. If the damages were created completely outside of the scope of their employment then a corporation will not be found to be liable for the damages but here based upon the facts Lenny was going to visit a prospective buyer and his driving to the meeting was within the scope of his employment.

What the corporation would have to argue is that while the accident occurred on his way to the meeting it did not benefit from Lenny's reckless driving and therefore the corporation would not be liable because the accident was caused by Lenny's negligence. This argument would most likely fail because a corporation can be held liable for negligent acts by their employees if they are not wandering too far from the scope of their employment and since Lenny was on the way to the meeting he was not wandering outside of the scope of employment and therefore the corporation can be held liable for the injuries caused to the pedestrian.

Lenny v. Pedestrian

The question would be whether Lenny could also be held liable due to his negligent acts. The Pedestrian would argue that Lenny negligently caused the injuries that he suffered and while as a SH of the corporation he might not be held liable he could still be held liable for negligently driving and causing the accident. The fact that Lenny was working in furtherance of the business interests of the corporation does not mean that he could not be held liable separately. Due to the fact that the accident was caused solely by his negligence Lenny could be found liable for the injuries to the plaintiff along with the corporation.

Molly v. Pedestrian

If a de facto corporation is formed then Molly cannot be held personally liable for the actions of the agents of the corporation. The only time a shareholder can be liable is if the plaintiff is able to pierce the corporate veil by showing that the corporation was merely an alter ego of the party or that it was underfunded. This is not the case here and therefore Molly would not be liable if a de facto corporation was formed.

General Partnership:

If the courts find that no de facto corporation was formed then Molly and Lenny would be in a general partnership with one another. A general partnership arises when two people agree to enter into a business venture for profit. That is demonstrated by the fact that previous to their attempted incorporation Molly and Lenny worked together selling software equipment and that they equally split their profits between each other. Under a general partnership the partners are not protected from liability like a shareholder of a corporation is. Therefore, if a general partnership is formed and a party brings a suit against one partner for damages arising out of their work for the partnership then all partners are personally liable for any award against the partnership. Therefore, unless Molly was able to argue successfully that Lenny's actions were

outside of the scope of the partnership then she would be held personally liable for any damages that are caused by the actions of Lenny. Because it does not seem likely Molly would be able to successfully argue that his actions were outside of the scope of employment, both Molly and Lenny would be personally liable for any injury suffered by the other party due to Lenny's accident.

Liability towards National Bank for Loan:

Corporation by Estoppel:

Even if a de facto or de jure corporation is not formed Molly and Lenny could argue that a corporation by estoppel was formed. Their argument would be that even if they were not a corporation the fact that National Bank dealt with them as if they were a corporation would estop them from denying that they were a corporation and holding the shareholders personally liable.

Software Inc. would be Liable

Software Inc. would be liable for the loan obtained from National Bank. The loan was taken out by them as a corporation and there does not seem to be any evidence to demonstrate that it was taken out for anything other than proper purposes. National Bank would try to argue most likely that Software Inc. is not liable for the loan because at this time Software Inc. only has negligible assets and therefore this would not provide much capital to repay the loan to National Bank.

Most likely Software Inc. would not be attempting to escape liability as they are already out of business and only have negligible assets so a recovery against them would not harm the corporation. This could lead National to make an argument to pierce the corporate veil because of undercapitalization but this argument would fail because the business was not undercapitalized; instead it was not able to fulfill the contract which was the basis on which National Bank loaned the money to them.

Because Software Inc. took out the loan and there is no evidence that it was used for any purposes other than to help the company they will be found liable to the bank for the loan and therefore National Bank will be able to bring an action against Software Inc., even though there is little for them to recover.

Molly would not be Liable

Unless a general partnership was formed as discussed above Molly will not be liable for the National Bank loan. The fact that National Bank acted as if it was dealing with a corporation would stop it from then asserting that it was in actuality a partnership and so therefore Molly would not be liable under a theory that it was merely a partnership.

As a shareholder in a corporation she is protected and there is no evidence to show that she did anything that would cause her to not be protected. National Bank might try to argue that it based its loan based upon the accounts receivable from the service contract developed by Molly but this argument would fail. She created the service contract within the scope of her employment and there is no evidence to show that she was at fault in any way for the failure of the business. Due to the fact that National Bank would not be able to show that Molly did anything that would make her liable for the losses suffered by Software Inc., a court would not find her liable to National Bank and she would therefore be safe.

Lenny would not be Liable

Due to the fact that Software inc. left negligible assets when it went out of business for National Bank to collect on they would most likely go after Lenny for the damages. Their argument would be the fact that the reason for the failure of the corporation was the fact that Lenny stopped working due to the car accident. They would argue that he was the person that created the revenue for the corporation through his sales calls and once he stopped working Molly did not have the experience

to continue running the business profitably and therefore by Lenny's actions the corporation went out of business. They would argue that his quitting was not in the scope of his employment and that it was in no way beneficial to the business and they would therefore argue that Lenny should be liable because their loss is due to Lenny's decision to not return to work.

Lenny would argue that even if his failure to go to work was the cause of the business to fail that does not make him liable for the debts entered into by the business. There is nothing here showing that Lenny or Molly did anything improper in obtaining the loan and that the loan was made with the corporation based upon the assets of the corporation and therefore Lenny should not be held liable.

Even though it seems like National Bank has an argument based upon the fact that the sole reason that the business failed was the fact that Lenny stopped going to work, this would not be sufficient to create liability on Lenny's behalf because the bank loan was entered into by Software Inc. and not with Lenny. Additionally, Lenny could argue that the loan was based solely upon the service contracts and not the sale of products, which was his main area of involvement. Alternatively, National Bank will argue that while it might have been prepared by Molly, Lenny was the one that sold the service contract and therefore it was his area of involvement. Even if the court found this they still would not find that Lenny had acted sufficiently in bad faith to find that he was liable to National for the loan.