Sample Exam 1
Business Associations

QUESTION 1:

Mary is a chemistry graduate student at the University of Kentucky. One day, she
discovers a method for aging bourbon more quickly than the traditional barrel-aged technique.
Mary’s chemically-aged bourbon tastes the same as barrel-aged bourbon, but it only takes a
month to mature, rather than the current industry average of seven years. This discovery could
up-end the entire bourbon industry. There’s just one catch… one out of every few batches makes
people sick.

After running the numbers, Mary decides that the liabilities associated with making
people sick are small potatoes compared to the financial upside of producing bourbon that
doesn’t need to age more than a month. She reaches out to two family friends – Peter and Paul –
to ask them to invest in her business venture, which she is calling Test Tube Bourbon. Mary
expects that a $1 million investment each by Peter and Paul will yield $10 million for each of
them over the next five years if the brand stays small, and that if they decide to ramp up
significantly – which might require bringing in more investors and/or going public – they could
make substantially larger amounts of money. She anticipates that the chances of a lawsuit from
sick customers is very high, but that settlements with sick customers will cost no more than $15
million, either in individual settlements or a single class action settlement. Assume a corporate
tax rate of 40 percent, and an individual tax rate of 20 percent.

a) How should Peter, Paul, and Mary structure Test Tube Bourbon? (20 minutes)

b) Suppose that Mary never tells Peter and Paul about the risk that the chemically-aged bourbon
will make people sick. They create a partnership, and then people get sick. Are Peter and
Paul liable for the harm Mary caused? Can they sue Mary? (25 minutes)

c) Suppose that Mary, as the person in charge of Test Tube Bourbon, pays people off as they
come forward about being sick. Because these people agree to confidential settlements, the
public has no idea that the bourbon is making people sick. Then Peter, Paul and Mary decide
to take their company public in order to raise cash. The stock market goes wild. People buy
much Test Tube Bourbon stock and the price rises. The firm does very well, becoming a
leader in the bourbon industry (and Mary turns out to be an adept CEO, fending off several
proxy battles and holding onto her seat for many years). Later, when the investing public
learns that Test Tube Bourbon is making people sick, the stock tanks. Describe the lawsuit(s)
that might result (besides the lawsuits brought by sick customers). (35 minutes)

d) Suppose that Mary discovers a way to change her manufacturing process so that no one will
get sick. But doing so increases her costs ever so slightly (and now that Test Tube Bourbon is
a large publicly traded firm, a small increase in production costs is a lot of money). She hires
a reputable outside firm to conduct a study that reveals that the cost of litigating with sick
customers is lower than the cost of implementing the new method. Mary presents this study
to the board and they agree with her to make no changes to the production method. Describe
the lawsuit(s) that might result (besides the lawsuits brought by sick customers) (15 minutes)
e) Suppose that Mary, knowing about the prospect of a very large lawsuit being brought against the firm, tells her brother to sell his stock in Test Tube Bourbon. He does not do so, but instead calls his pastor and tells him to dump his stock holdings. Consider three scenarios: (25 minutes)

1. The pastor makes a fortune on this information. Is he in trouble?

2. Suppose the pastor tells his congregation and some of them trade on it – are they in trouble?

3. Suppose that the pastor routed all the earnings through a bank account and this activity netted the bank substantial fees. Is the bank in trouble?

f) It turns out that Mary’s chemical-aging process relies on chemicals derived from trees unique to the Amazon rainforest. This is a very small part of the operation’s expenses: less than $1 per $100 spent on each batch of bourbon goes towards these chemicals. But because Test Tube Bourbon is such a success, these trees are now at risk of becoming endangered as a result of deforestation. On May 1st, three years after Test Tube Bourbon goes public, an environmentally-minded investment fund, GreenReturns, buys 2% of Test Tube Bourbon’s shares. GreenReturns holds onto the shares for a year and a day, at which point they propose a shareholder resolution that would require Test Tube Bourbon to undertake a study to look into alternative methods of producing the bourbon in more environmentally friendly ways. The shareholders’ meeting is coming up very soon (it’s being held the first week of July at Keeneland). Can Mary stop the proposal? (10 minutes)

g) GreenReturns is turning out to be a real problem for Mary. Now they are seeking to oust her from power because, they say, she harming the environment and eventually there will be no more trees of the sort needed to make Test Tube Bourbon a success. They seek to wage a proxy contest to get her out, but they need access to the list of stockholders. They make a written demand, stating their reasons. Will they get the list? (10 minutes)

h) While GreenReturns is causing Mary substantial stress, she has another issue to deal with. It turns out that while Test Tube Bourbon was just getting started, but before it went public, Mary was approached by a firm that wanted her to consult on aging Scotch (which is like bourbon but made primarily with barley). She advised the Scotch-making company and was paid very handsomely, but this was not discussed with or disclosed to Peter and Paul. They are now upset and are threatening to sue Mary. Assess their chances of success under three scenarios: (20 minutes)

1. Suppose Test Tube Bourbon was a partnership at the time

2. Suppose Test Tube Bourbon was a corporation at the time

3. Suppose Test Tube Bourbon was an LLC at the time
QUESTION 2 (20 minutes)

Is limited liability – allowing investors to pour money into a company but not be liable for the company’s misdeeds – a good thing? What considerations help you evaluate whether it is good or bad? Are there other ways of achieving the benefits provided by limited liability without the costs? Please discuss with reference to the cases we read.