

**University of Illinois College of Law
Examination Cover Sheet**

Business Associations 2

Professor Amitai Aviram

Spring Semester 2013

Number of Pages: 4 (including this page)

Time Allotted: Until 10am on the day following the day you received the exam

Exam Instructions

1. **Permissible material:** This is an open book exam. You may use any materials you want, whether in hardcopy or electronic format.
2. **Anonymity:** The exams are graded anonymously. Do not put your name or anything else that may identify you (except for your four-digit exam ID number) on the file that contains your answer to the exam.
3. **Receiving and submitting the exam**
 - a. You must personally pick up a copy of the exam from Tina Lamb (Dean's suite) between 9-10am on one of the following days: May 1, 2, 3, 6.
 - b. You must submit your response as a .doc (Microsoft Word) file e-mailed to Tina Lamb (tinalamb@illinois.edu) no later than 10am on the day after you received the exam. The file name should be your 4-digit exam ID number.
4. **Confidentiality**
 - a. Once you receive this exam form, you are not allowed to discuss the exam with anyone until after the last day of the exam period.
 - b. Students who are enrolled in this course are not allowed to solicit or receive information about the exam if the source of this information (directly or indirectly) is a person who has seen the exam.
 - c. After the last day of the exam period, you are allowed to freely discuss the exam.
5. **Writing the exam**
 - a. Unless the exam question specifies otherwise, assume that the relevant jurisdiction applies the Restatement (Third) on Agency, Delaware corporate law RUPA, and U.S. securities law.
 - b. Cite relevant case and statutory authority.
 - c. Within the constraints of the length limit, answer all relevant issues that arise from the fact pattern, even if your conclusion on one of the issues is dispositive to other issues.
6. **Length limit**
 - a. The total length of your answer should not exceed 1,000 words.
 - b. **For every 10 words in excess of the length limit (rounded up), one point will be taken off the exam's raw score.**
7. **"Fact" patterns are fiction:** The "facts" presented in this exam were constructed for an educational purpose, and are not intended to inform about any real person or event.

Money out of mud: Dig, Inc. (“Dig”) is a publicly-traded Delaware corporation that manufactures high-end excavation equipment. Dig sells its products world-wide, and in recent years it had been doing particularly well in the (fictitious) country of Elbonia. Elbonia exports its high-quality mud, and Dig’s equipment is popular among Elbonian mud miners. As a result (and because Elbonia charged very low corporate taxes) most of Dig’s profits in recent years came from dividends paid to it by Mining Company of Elbonia (“MCE”), a Delaware corporation that is Dig’s Elbonian subsidiary. MCE has a single class of shares, and Dig owns 85% of them. Five Elbonian investors each own 3%. All shareholders have held their shares for many years. MCE is not publicly traded. Its board consists of five directors: Ella is an Elbonian MSH; Isaac is an Elbonian citizen who is unaffiliated with any MCE shareholder, and who was nominated as director because of his expertise in Elbonian law and politics; the other three directors are American, and are also unaffiliated with any MCE shareholder.

In past years, whenever MCE received an order for Dig’s equipment from an Elbonian customer, it would contact Dig, and Dig would sell the equipment to MCE at the cost of production (i.e., with no profit). MCE would then sell the equipment to the Elbonian customer (at a profit, of course). At the end of each year, MCE would give away all of its annual profits as dividends to its shareholders. MCE never sold equipment to customers outside of Elbonia, and Dig never directly sold equipment to Elbonian customers, but neither company signed an agreement obligating it to do so.

Poisoning our reputation: This system worked well until the ShiftyCo incident. ShiftyCo was an American company selling to the Elbonian mud mining industry chemicals needed to refine raw mud into premium muck. ShiftyCo sold defective chemicals to Elbonian miners, and those chemicals polluted groundwater, imposing high cleanup costs on the Elbonian government. The Elbonian government sued ShiftyCo in Elbonia for the cleanup costs and ShiftyCo was found liable, but the judgment was unenforceable. Like MCE (and other foreign-owned Elbonian companies), ShiftyCo distributed all of its profits as dividends, so it lacked assets to satisfy the judgment against it. Many Elbonians perceived the ShiftyCo incident as an exploitation of Elbonia by foreign companies. Responding to political pressure, the Elbonian legislature passed a law that imposed a 50% tax on the payment of dividends to foreign investors.

Renegotiating the relationship: The new tax made it undesirable for Dig that MCE would distribute dividends. Cheryl, Dig’s CEO, told MCE that Dig would not sell MCE any more equipment unless a new arrangement was made to transfer MCE’s profits to its investors in a tax efficient way (that complies with Elbonian and US laws).

MCE’s BoD appointed Isaac as a special board committee authorized to negotiate with Dig and recommend to the BoD whether to enter a formal agreement with Dig on their relationship and on what terms. The board provided the committee with funds to hire independent advisors as it saw fit, and Isaac used those funds to hire a corporate lawyer and a business consultant, both of whom had no prior connection with MCE or Dig. After a week of negotiations, Cheryl and Isaac signed a long-term supply agreement (“the Agreement”) under which, for a period of 25 years, Dig agreed to sell to MCE its equipment at the cost of production, and MCE agreed to pay Dig a franchise fee equal to 20% of its revenue from Dig equipment (i.e., 20% of the price at which MCE sold Dig

equipment to its customers). Dig also promised not to sell its products directly to Elbonian customers, and MCE promised not to sell Dig products directly to non-Elbonian customers. The 20% franchise fee was determined because MCE's profits were historically on average equal to 20% of its revenue. The lawyer that Isaac hired opined that the supply agreement complied with Elbonian tax law, and the financial expert opined that the supply agreement was an efficient way to minimize MCE's tax liability.

Dissent: Isaac wrote a detailed report to the board explaining the process of the negotiations, the information he and his advisors considered, and the reasons that led him to believe that the Agreement was the best option for MCE. When the Agreement was brought for approval to MCE's BoD, Ella was upset that the Agreement would result in MCE never distributing a dividend, since (unless it became more profitable) MCE would have no profits left after paying the franchise fee.

Isaac responded that the special committee explored and rejected two other options: buying the machines from Dig at a premium above their cost of production (which Dig was not willing to do because it would then be required to pay higher taxes in the US) and cutting ties with Dig entirely (which the committee thought was unpractical since MCE had no other business besides selling Dig equipment, and did not appear to have a competitive advantage in entering a new business). As for the size of the franchise fee, Isaac said this was the best he could negotiate, and Dig made it clear that it wouldn't accept a lower fee. After thoroughly questioning Isaac, the directors voted and approved the Agreement, 4-1, with Ella voting against it. Ella then demanded that the Agreement be brought to shareholders for approval in the coming shareholder meeting. The board held a vote and decided, 4-1, not to have the shareholders vote on the Agreement.

That evening Ella wrote a letter to the rest of the board, in which she demanded as a shareholder that the board include - in the meeting agenda and on any proxy cards it will send the shareholders - a vote on her shareholder proposal, which stated: "Resolved, that MCE rejects the Agreement with Dig and is not bound by it." In the next board meeting the board voted 4-1 (again, with Ella dissenting) to exclude Ella's proposal.

The following day Eric (an MCE MSH) spoke with Isaac and requested that the Agreement be discussed at the shareholder meeting. At the next board meeting, Isaac told the other directors he now thought it best to allow MSHs (all shareholders except Dig) an advisory vote on the Agreement. The board unanimously agreed, and included the advisory vote in the meeting agenda.

When MCE's shareholder meeting took place (after being lawfully called), three of the MSHs (including Ella) attended, as did Cheryl (who represented Dig's shares). Ella voted against the Agreement, but the other two Elbonian investors present at the meeting voted in support of the Agreement. Following the meeting, MCE's BoD informed Dig that MCE has approved the Agreement.

Ella sued: (a) requesting an injunction requiring the board to include her proposal; and (b) requesting an injunction against implementing the Agreement, because Dig had allegedly breached its fiduciary duties in causing MCE approve the Agreement, which will (allegedly) divert all of MCE's profits to Dig.

Freeze & counter-freeze: While Ella's suit was pending, Cheryl concluded that the Elbonian dividend tax made it unsustainable in the long-run to have a company jointly owned by Elbonians and non-Elbonians. She proposed to MCE's board that Dig would acquire MCE in a triangular merger, in which MCE would merge with a Dig's shell subsidiary, and MCE's MSHs would be cashed out at \$150/share ("the Freezeout").

MCE's board again appointed Isaac as a special committee to investigate whether such a merger was in the interest of MCE's MSHs, and if so, to negotiate with Dig for the best terms possible for the MSHs. Again, funding was given to hire appropriate experts, and Isaac hired an M&A lawyer and an investment banker, both of whom had no prior connection with MCE or Dig. After a thorough investigation and intense negotiations Cheryl and Isaac agreed on the terms of the Freezeout, including a higher price of \$165/share, and Isaac concluded in a detailed report to the BoD that in his opinion the Freezeout is in the interest of MCE's MSHs.

Just before MCE's board met to discuss whether to approve the Freezeout, Eric, one of MCE's MSHs, learned of the negotiations with Dig and made a counter-offer to the board, to have MCE merge with a firm wholly-owned by Eric, cashing out all other shareholders (i.e., 97% of MCE's shares) at \$170/share ("the Counter-freezeout"). Eric asked the board not to approve (Dig's) Freezeout until the board considered and decided on his (allegedly superior) Counter-freezeout.

MCE's board met, discussed the Counter-freezeout, and after thorough investigation agreed unanimously (5-0) to approve the Freezeout and not to negotiate with Eric for the following reasons:

- (1) For Eric to succeed in the Counter-freezeout he would need to receive Dig's support in the shareholder vote, and Dig insisted that it wanted to buy the remaining shares in MCE, not sell its own shares, so the Counter-freezeout had no chance of succeeding.
- (2) Since Eric would need to buy 97% of MCE (while Dig would only need to buy 15%), Eric would need to raise a lot of money for the Counter-freezeout. The board believed Eric could not raise that much money and expected he would fail to finance the Counter-freezeout.
- (3) MCE had always been a Dig subsidiary and had Dig's corporate culture, which the board concluded had contributed to MCE's success. A merger with Eric would cause MCE to lose this beneficial corporate culture.

Eric sued MCE's board, alleging that it breached its fiduciary duties by not attempting to get the best deal for MCE's shareholders.

Discuss both Ella's suit and Eric's suit. Defendants waived, and you shouldn't discuss, claims related to whether either suit is derivative.

Model answer for Spring 2013 BA2 exam:

1. Ella's suit – proxy access

MCE is not a public company, so SEC Rule 14a-8 does not apply to it. BoD's plenary authority under DGCL §141(a) includes setting the SH meeting agenda. DGCL §112 allows a corporation to create proxy access arrangements in its bylaws, but by default SHs have no right to proxy access, so Ella's suit will fail.¹

2. Ella's suit – controller FD

a. **Duty:** Dig owes fiduciary duties to MCE's MSHs if Dig controls MCE. A SH is presumed to control if she owns over 50% of the shares (*Ivanhoe Partners*). Here, Dig owns 85%, so it controls MCE.

b. **SoR:** *Kahn* applies because Dig is on both sides of the Agreement: as the seller of Dig equipment it wants high franchise fees; and it controls MCE, which as the buyer would want to pay low franchise fees.² Under *Kahn*, SoR is entire fairness.

c. Application

Under *Kahn*, if MCE received the approval of either a committee of independent directors or of the majority of MSHs, then BoP shifts to plaintiff to show unfairness.

(i) Isaac acted as a committee of independent directors and was independent of Dig. He had funding to hire relevant experts and used it. His mandate included the ability to walk away from any deal with Dig, and his report shows that he explored that possibility.³ This protection seems robust.

(ii) A majority of MSHs present at the SH meeting approved the Agreement (which was lawfully called and had quorum), but this is not a robust protection because the vote was advisory (non-binding), and approval must come from a majority of all MSHs (>7.5% of the 15%), not just the majority of MSHs present at the vote. This protection isn't robust.

Kahn (unlike *Hammons* or *CNX*) requires only one of the two protections, so BoP is shifted to Ella to show unfairness. The Agreement seems unfair because it allocates (on average) 100% of MCE's profits to Dig and none to the MSHs. However, MCE may retain profits if it cuts costs or raises prices so that its profits exceed the historic 20% of revenue. Since Dig has a lot of commercial leverage over MCE (as the sole source of MCE's products), MCE might have agreed to these terms even if it weren't controlled by Dig, with the hope that it can profit by improving efficiency. Given that BoP is on Ella, she likely fails.

¹ *Blasius* only applies when the BoD interferes with the SHs' franchise. When SHs don't have proxy access rights, proxy access isn't part of the SH franchise, so *Blasius* doesn't apply here.

² *Sinclair* is a fallback, general test that applies when neither *Kahn* nor *Hammons* apply. Since *Kahn* clearly applies here, it and not *Sinclair* is the appropriate test.

³ The committee is severely constrained due to MCE's weak bargaining position, but this is not relevant to the assessment of its mandate and authority, because this weakness would exist even if Dig did not control MCE (i.e., the position would be no better in arm's-length negotiations).

3. Eric's suit

a. Duty: yes, as MCE's directors.

b. SoR: The BoD is not self-dealing because none of the directors are affiliated with Dig, so entire fairness does not apply.⁴ Enhanced scrutiny does not apply under *Unocal*, because the board did not implement a takeover defense. However, once the board decided to negotiate the Freezeout,⁵ it has “embark[ed] on a transaction... that will result in a change of control” (from concentrated control by Dig to sole control by Dig).⁶ Under *Lyondell*, this triggers *Revlon* duties, which include using the enhanced scrutiny SoR.⁷

c. Application

(i) BoD must find, in good faith & after a reasonable investigation, that the MCE's interests warranted the challenged action

- a. Good faith: no evidence of lack of good faith or of self-dealing.
- b. Reasonable investigation: deliberation and investigation seem adequate.
- c. Corporation's interest (threat): The application of *Revlon* limits the legitimate threats the board may consider to short-term ones. Therefore, the corporate culture justification (allowed in *Paramount*, where *Revlon* duties did not apply) would not be permissible. The futility justification (that Counter-freezeout would fail since Dig doesn't want to sell) is not entirely sound – Dig prefers to buy than to sell, but the board can refuse to accept the Freezeout and implement takeover defenses, in which case Dig would have the choice of being stuck with Elbonian MSHs or selling MCE to them – and it might then prefer the latter. The financing justification is legitimate under *Revlon* – it's in SHs' short-term interest not to forego one offer in order to accept another offer than will fail for lack of financing (analogous to antitrust justification in *Dollar Thrifty*).

(ii) Board action must be a reasonable way to achieve that interest: Refusal to negotiate with Eric is not preclusive to his offer – he can attempt a hostile acquisition (though it would fail because Dig would reject it). While Eric can argue that MCE's BoD should have at least used his offer to extract a higher price from Dig, failing to do so did not violate *Revlon* duties in *Dollar Thrifty*. If the sole reason for rejecting the Counter-freezeout is inadequate financing, however, the board might require Eric to prove he has financial ability to undertake the offer (or require that Eric compensate MCE with a termination fee if he fails to secure financing for the deal), which would address the threat without losing an alternative offer for MCE.

⁴ *Kahn, Hammons and Sinclair* are not applicable here, since they address controller FDs, while Eric is suing MCE's BoD.

⁵ It is negotiating the Freezeout, not the Counter-freezeout, which triggered *Revlon*. Some exam answers claimed that receiving the Counter-freezeout triggers *Revlon*, but MCE's BoD refused that transaction, so it did not “embark” on it. It can't claim “just say no” defense, though, since it “embarked” on the Freezeout.

⁶ Shifting from concentrated to sole control is a change of control that can trigger *Revlon*, since a controller who wants sole control would pay a premium to get it, and *Revlon* protects MSHs' right to that premium.

⁷ Some exam answers suggested that paying cash for shares is a separate trigger for *Revlon* duties. It is not. *Revlon* only applies when BoD embarks on a transaction that would lead to change of control. Cashing out SHs is a relevant fact in assessing whether a change of control takes place, but it is not a separate test.