

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

**Business Associations I**

Professor Amitai Aviram

Fall Semester 2008

Number of Pages: 5 (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 student number) on the file that contains your answer to the exam.
3. **Receiving and submitting the exam:** You must personally pick up a copy of the exam from Angela Martin (Room 338) between 9-10am on the day of your choice among the following: December 10, 11, 12, 15, or 16. You must submit the exam, by e-mail to Angela Martin (aymartin@law.uiuc.edu), no later than 10am on the day following the day you received the exam.
4. **Confidentiality**
  - a. Once you receive this exam form, you are not allowed to discuss the exam with anyone until after the final day of the exam period for this semester (which may be later than the day of the exam).
  - b. Students who are enrolled in this course are not allowed to solicit or receive information on 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 for this semester, you are allowed to freely discuss the exam.
5. **Writing the exam**
  - a. The exam contains two questions. Answer one of them. I will grade only the question you answered first.
  - b. Unless the exam question specifies otherwise, assume that the relevant jurisdiction applies the Restatement (Third) on Agency, RUPA, and the DGCL.
  - c. Cite relevant case and statutory authority.
  - d. When writing anything the source of which is neither your original thought nor part of the course material, you must give a complete citation of the source in a footnote.
  - e. 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:** If you answer question 1 –
  - a. The total length of your answer should not exceed 1,000 words. Footnotes are not included in this count.
  - b. **For every 10 words in excess of the length limit (rounded up), one point will be taken off the exam's raw score.**
  - c. Footnotes may only contain citations and descriptions of the content of cases and statutes that are not in the course material.
  - d. This section does not apply to students answering question 2.
7. **"Fact" patterns are fiction:** The "facts" presented in this exam were constructed for an educational purpose, and are not intended to refer to or inform about any real person or event.

## **Question 1**

**Welcome to Elbonia:** The People's Republic of Elbonia, which was first brought to the attention of the American public in the Dilbert cartoon strip, is a developing country that suffers from corruption and civil strife. In an effort to attract foreign investment, Elbonia adopted the Restatement (Third) on Agency, RUPA and Delaware corporate law (both DGCL and Delaware case law).

Elbonia's primary natural resource is mud, which Elbonia has in abundance. Until a few years ago, Elbonia had a planned economy and the business of mud mining was exclusively in the hands of government-owned corporations. Because there was little use for the mud that was mined, the government-owned corporations simply stored the mud they mined in huge warehouses. Without a market for the mud, they accumulated huge losses that threatened to bankrupt the country.

**Mud to Gold:** In a stroke of luck for Elbonia, scientists have found a way to produce ethanol from mud. Elbonian mud proved to be of particularly high quality, making Elbonian mud-based ethanol cheaper and more environmentally friendly to produce than corn-based ethanol. As a result, foreign investors clamored to gain access to Elbonia's rich mud fields.

The Elbonian government decided to privatize its mud-mining industry. It shut down its mud-mining corporations, and announced that it would auction to one private corporation an exclusive license to mine all Elbonian mud. A dozen foreign and Elbonian firms participated in the auction.

Among these participants was Backstab, Inc. ("Backstab"), an Elbonian corporation wholly-owned by Ruth Less, a former Elbonian army general turned businesswoman (who was also Backstab's sole director). Another participant was United Mud Industries Corp. ("UMIC"), a Delaware corporation that is a world leader in mud refining (the process of converting mud to ethanol).

**If you can't beat 'em:** A few days before the auction was to take place John, UMIC's CEO, met with Elbonian officials who told him (confidentially) that it was politically necessary for the Elbonian government to award the license to Backstab, because Ruth was very well connected to the current Elbonian regime.

Realizing that UMIC's bid would not be selected, John asked to meet with Ruth. He presented her with evidence that UMIC had the most efficient mud refining technology and the largest distribution network to sell refined ethanol. They both knew that Backstab lacked the technology, the distribution network and even the financial resources to efficiently exploit the mud license, but also that regardless of its business capabilities, Backstab would receive the exclusive license to mine Elbonian mud.

After some negotiations, Ruth and John agreed on the following plan: UMIC would lend to Backstab \$1 million for 10 years, at an interest rate of 2% plus 20% of the profits Backstab will make from the mud business (in a year that Backstab lost money in the mud business, 20% of that loss would be deducted from the interest payment). John will replace Ruth as Backstab's CEO since he had experience in the mud mining business. Backstab will expand its board to 2 directors, and appoint John as the second director (Ruth would continue to be a director). Ruth agreed to give an irrevocable proxy to an independent third party to vote all of her shares in accordance with the agreement (i.e., to elect and maintain both Ruth and John as directors). Finally, Backstab agreed to sell all of its mud to UMIC at a 10% discount to the market price of mud at the time of the sale.

**Growing tensions:** UMIC's and Backstab's BoDs both approved this agreement following proper procedure. Backstab hired John as its CEO and elected him as Backstab's second director (he remained the CEO of UMIC as well). UMIC then withdrew its bid for the mining license, Backstab amended its bid to provide the Elbonian government with the details of the agreement with UMIC, and the Elbonian government awarded the mining license to Backstab.

The first year of operations went smoothly. Backstab hired several UMIC experts to oversee the mud mining, and the combination of UMIC's technology and Elbonia's plentiful and accessible mud resulted in production costs that were more than 20% cheaper than the market price of the mud. Both Backstab and UMIC benefitted.

After a year Ruth felt that Backstab had the expertise and the accumulated profits to expand its operations outside of Elbonia. Ruth asked John to have Backstab bid for a license to mine mud in Mud Island, which is within the city limits of Memphis, Tennessee, USA. John told Ruth that UMIC was handling the American market and that Backstab should stick to Elbonian operations. The deadlock on the BoD prevented Backstab from bidding for the Mud Island license.

The only issue on which the BoD was not deadlocked was dividend distribution. The BoD distributed all of Backstab's profits (after paying its obligations including interest payments to UMIC) to its shareholder Ruth. From Ruth's perspective this was desirable because she lacked control over Backstab and therefore wanted to take as many of its assets back into her control (by receiving them as dividends). From John's perspective, keeping the company "lean" (i.e., with no cash reserves) was a way to ensure it didn't have the ability to expand operations outside of Elbonia. Thus, Backstab operated with just enough money to fund its operations (and pay UMIC interest on the loan), distributing as dividends any additional money it earned.

Relations between Ruth and John deteriorated further later that year. Backstab had already mined the most accessible mud, and the mud it was mining now was harder to access and therefore more expensive to produce. Production costs were now only about 5% below the market price of mud. However, under the agreement with UMIC, Backstab had to sell the mud at a 10% discount, and therefore Backstab began to lose money. Ruth demanded that the agreement would be modified so that UMIC would pay

Backstab the market price of mud (without a discount), but UMIC refused to renegotiate the agreement. Ruth wanted Backstab to renege on the agreement and take her chances in the Elbonian courts (where she had friends and influence), but John refused to breach the contract and therefore Backstab's BoD was, again, deadlocked. John, a meticulous person by nature and now particularly alarmed at the possibility of future litigation between UMIC and Ruth, kept careful records of all of Backstab's BoD decisions and financial transactions, and regularly monitored those records to ensure they were complete and correct.

**Dear John:** Larry, Backstab's Chief Personnel Officer and a close ally and friend of Ruth, sent the Elbonian immigration authorities an official letter announcing that a number of Backstab's foreign employees, including John, were no longer necessary for the company's business. The Elbonian immigration authorities then notified John that his visa to reside and work in Elbonia was revoked. John was forced to leave Elbonia, and manage Backstab from the US.

Ruth then announced a board meeting, to be held in five days in Elbonia. She e-mailed the notice to John, and told him that in the interest of confidentiality, they would not hold the meeting via teleconference, and John must come to Elbonia if he wished to attend the meeting. Under Elbonian law, John was not allowed to enter Elbonia now that his visa was revoked. Therefore, only Ruth attended the board meeting. At the meeting, Ruth determined that John could not effectively manage Backstab from the US (as his inability to attend the BoD meeting demonstrated), and therefore she (as the BoD) fired John and promoted Larry to the CEO position.

**Backstab becomes insolvent:** Immediately upon assuming the position of CEO, Larry discovered that Backstab's financial situation was dire. It had no cash reserves because its mud production costs were higher than the price it was obligated to sell the mud to UMIC. To finance its operations, a few months ago John caused Backstab to borrow \$10 million from Bob's Bank, Inc. ("BBI"). Now, Backstab did not have any more cash to pay the interest on BBI's loan, and the loan was in default.

BBI sued Backstab to recover the debt, and a court entered judgment in favor of BBI for \$10 million (i.e., you can assume that Backstab is liable to BBI for the \$10 million, and do not need to analyze the issue of Backstab's liability to BBI). Backstab only had enough assets to pay \$2 million. BBI collected the \$2 million, then sued Ruth and UMIC for the remaining \$8 million.

**Discuss BBI's suit against Ruth and UMIC.**

## **Question 2**

Real world note: Papa John's International, U.S. Bancorp and Calistoga Bakery Café are real companies, and you are expected to find publicly-available information on them and use it in your analysis. To my knowledge, the transaction that is the subject of this analysis is fictitious.

**From:** Wendy I. Zeller [mailto:Ms.WIZ@work.com]  
**To:** The WIZ Associate  
**Sent:** Wednesday, Dec. 10, 2008 9:00 AM  
**Subject:** Papa John's International, Inc. ("PZZA")

The Board of Directors of Papa John's International, Inc. (NASDAQ: PZZA) has retained us to advise it regarding a transaction proposed by its CEO, Nigel Travis. I am travelling back today from a meeting in Europe and will return to meet tomorrow morning with PZZA's board.

Mr. Travis proposes a transaction with Calistoga Bakery Café ("Calistoga"), a firm partially owned by John Schnatter, PZZA's founder and chairman of PZZA's board. Mr. Travis wants PZZA to purchase from Calistoga the intellectual property and know-how to produce Calistoga's soups and sandwiches. He believes that these items would complement PZZA's current offerings, and would expand PZZA's appeal to new customers who prefer a 'soup & sandwich' restaurant.

Mr. Travis collected some information on similar transactions, and based on his preliminary analysis, he believes \$10 million would be a reasonable price (of course, he would be very happy if PZZA paid less). Mr. Travis said that PZZA does not have \$10 million in cash available for the purchase, but can and should borrow \$10 million to finance the purchase. He has made a few phone calls to potential lenders. Several banks were willing to lend smaller amounts, but Mr. Travis believes it is best to borrow the entire amount from a single lender. Only one lender among those Mr. Travis contacted agreed to lend \$10 million – US Bancorp (NYSE: USB). Mr. Travis recommends that USB will finance the transaction.

That's what I know about the transaction. I need you to prepare, by 10 am tomorrow, a memo explaining in detail the process you believe is needed to minimize the likelihood that this transaction is successfully challenged in court. PZZA is going to use your memo as the blueprint for addressing this transaction proposal, so make sure to spell out all of the relevant steps, details and legal issues that come up.

Gather the information you need from public sources. I expect that public information should be enough for this preliminary analysis, but if you need additional information that is not available publicly, let me know exactly what you need and I will ask PZZA to provide us with answers.

Thanks!

## Business Associations I – Fall 2008

### “Bare bones” Answer to Question 1 (not including research component)

#### I. BBI vs. Ruth<sup>1</sup> – Can BBI PCV to Ruth?<sup>2</sup> No

Under *Sea-Land*, the test for piercing the corporate veil is:

- (a) Such unity of interest between Backstab and Ruth that their separate personalities no longer exist: here, this is a weak claim. The only thing that creates a unity of interest is that Ruth owns 100% of Backstab and she regularly receives as dividends all of Backstab’s profits – this is similar to *Walkovszky*. But she does not control Backstab (BoD is deadlocked and John effectively controls it as CEO), careful records are kept of the dividend distribution and other corporate records, and Ruth does not treat Backstab’s assets as her own (unlike *Sea-Land*). Therefore, no unity of interest.
- (b) Adherence to fiction of separate corporate existence would sanction fraud or promote injustice – Backstab was undercapitalized. This would promote injustice to tort creditors, but not to contract creditors like BBI. BBI could have inspected the books and seen Backstab’s precarious financial position, and perhaps it did and priced the loan accordingly. There was no lack of formalities that would thwart contractual protection by BBI, and therefore respecting Backstab’s corporate veil does not promote injustice to BBI.

#### II. BBI vs. UMIC – Partner’s liability (Martin)

##### 1. Are Backstab and UMIC partners?<sup>3</sup> Yes

(a) RUPA 101(6), 202(a): Partnership is “an association of two or more persons to carry on as co-owners a business for profit.” This is a business for profit (mud mining), involving two persons – Backstab and UMIC. Co-ownership requires:

- (i) Shared profits: UMIC shares 20% of profits & losses (with losses capped at \$20,000/year – the annual interest payment). Shared losses was seen as a relevant factor in *Fenwick*.

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<sup>1</sup> BBI may argue that Ruth violated her fiduciary duty as director by distributing dividends in a manner that kept Backstab undercapitalized. Normally, directors owe fiduciary duties to the corporation & SHs, not creditors. However, in situations of insolvency directors may owe fiduciary duties to creditors (*Francis*). I mentioned duties to creditors in insolvency briefly in class when reviewing *Francis*, but did not elaborate. Therefore, this issue was considered part of the research portion of the raw score, but students were not expected to raise this issue.

<sup>2</sup> Some students used a PCV argument for UMIC’s liability, claiming UMIC had enterprise liability for Backstab’s obligations. This is a very weak argument under the circumstances. Enterprise liability applies to sister companies. UMIC & Backstab are not sister companies (their shareholders are not identical and do not even overlap).

<sup>3</sup> Note that this partnership is NOT between Ruth and John – In negotiating the agreement, John is clearly acting on behalf of UMIC, and Ruth is acting on behalf of Backstab. It is Backstab, not Ruth, that will undertake the mud mining operations. Therefore, the partnership (*Martin*-based) argument is irrelevant to Ruth’s liability.

(ii) Shared control: John, UMIC's representative, is 1 of 2 directors and the CEO of Backstab, which runs the mud mining operation, effectively controlling the operation. This is different from *Martin*, in which control of the debtor by the creditor was less absolute. There, Hall, a partner is the debtor, ran the debtor. Here John, the creditor's CEO, runs the debtor.

2. Does Backstab's loan from BBI bind the partnership? Yes

(a) Is borrowing money to finance operational expenses an action in the ordinary course of a mud mining business? I think so. If they are, then under RUPA 301(1) Backstab's loan binds the partnership unless Backstab had no authority to borrow money to finance its operational expenses, and BBI knew Backstab lacked authority. In this case, it seems that there was no limitation on Backstab's ability to borrow money to finance its operational expenses, and even if there was such a limitation, there is no evidence that BBI was aware of this. Therefore, the partnership is liable for the borrowed money.

(b) Even if borrowing is considered outside the ordinary course of the mud mining business, under RUPA 301(2) the act binds the partnership if authorized by the other partners. In this case, it is very likely that the act of borrowing was authorized: (i) day-to-day financing of the business is a task that is usually given to the CEO; (ii) In this case, though John's act is considered the act of one partner (Backstab), John is also the CEO of the other partner (UMIC) and guard's UMIC's interests. It is therefore likely that UMIC gave John broad authorization.

3. Is UMIC liable as a partner? Yes

Under RUPA 306(a), a partner has unlimited liability for the partnership's obligations incurred while he was a partner. RUPA 307(c) requires obtaining a judgment against the partner, not just the partnership (which is why BBI sued UMIC). RUPA 307(d) requires the creditor to exhaust remedies against the partnership before levying execution against a partner, but in this case the remedies were exhausted. BBI obtained a \$10M judgment against Backstab, and was able to collect only \$2M.

**III. BBI vs. UMIC – Agency liability (*Cargill*)**

1. Is Backstab UMIC's agent? Yes

Restatement 1.01: Agency is the fiduciary relationship that arises when:

(a) P manifests assent to A that A shall act

(i) On P's behalf – Backstab supplies all of the mud it mines to UMIC – essentially acting as UMIC's Elbonian branch (analogous to Warren in *Cargill*).

(ii) Subject to P's control – UMIC's CEO is appointed as Backstab's CEO and director, allowing him to dominate Backstab's behavior. This is significantly stronger control than *Cargill* had over Warren. However, this case is weaker than *Cargill* in that no facts suggest that UMIC represented to BBI that it backs Backstab, unlike the *Cargill* forms given to the farmers by Warren (UMIC did represent to the

Elbonian government that it is working with Backstab; also BBI may know that John is UMIC's CEO).

(b) A manifests assent to so act – Backstab's assent is evident from its implementation of the agreement.

## 2. Was Backstab authorized? Yes

(i) Express actual authority – John (as UMIC's CEO) can be seen as authorizing his borrowing (as Backstab's CEO) – this is particularly reasonable given that the borrowing is needed to allow Backstab to continue to sell mud to UMIC at a 10% discount.

(ii) Implied actual authority - If only UMIC's BoD can authorize, authorization may be implied in approving the agreement, since it appointed John as CEO, and it is reasonable that a CEO is authorized to borrow money to finance operating costs.

(iii) Apparent authority – Assuming BBI knew John was also UMIC's CEO,<sup>4</sup> they could reasonably believe he is authorized by UMIC, as well as Backstab, to borrow money to finance operational expenses.

(iv) Estoppel – Assuming UMIC knew that BBI may know that John was also UMIC's CEO, Restatement s.2.05(2) may estop UMIC from denying both agency and liability. This knowledge would put UMIC on notice that a third party may justifiably believe that John has authority to borrow on behalf of UMIC (through Backstab), and make a detrimental change in position (lend money) based on that belief.

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<sup>4</sup> If you assumed that BBI did not know John was also UMIC's CEO, an analysis of the special rule on the liability of undisclosed principals (Restatement s. 2.06) would be appropriate here.