University of Illinois College of Law
Examination Cover Sheet

Business Associations I
Professor Amitai Aviram
Fall Semester 2009
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 four-digit exam ID 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 Tina Lamb (Room 324) between 9-10am on the day of your choice among the following: December 9, 10, 11 or 14. You must submit the exam, by e-mail to Tina Lamb (tinalamb@illinois.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. 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.
   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. 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

The Really Big Corporation of America: Really Big Corporation of America ("RBCA") is a Delaware corporation that is listed on the New York Stock Exchange ("NYSE"). RBCA is a manufacturer of gas-guzzling widgets ("GGWs"). Because GGWs consume a lot of gasoline, RBCA's profits are highly cyclical, with GGW sales (and profits) being very low when gas prices are high, and conversely sales and profits are very high when gas prices are low. These cycles last between 5 and 10 years (i.e., 5 to 10 years pass from the time gas prices peak to the time gas prices bottom out).

RBCA has two classes of shares: common shares ("Cshares") and cumulative non-participating preferred shares ("Pshares"). According to RBCA's certificate of incorporation, Cshares and Pshares have identical voting rights (one vote per share); Pshares have a cumulative right to dividends of $10 per year per share, but do not participate in any remaining dividends. If RBCA is dissolved, Pshares have priority over Cshares for $50 per share plus any amount of accumulated dividend that has not been paid to them. Beyond that, all remaining assets belong to the C-shareholders. RBCA has issued 1 million Cshares and 1 million Pshares.

Dividends ditched: When Dhammika was appointed as RBCA's CEO, its profits were very low because gas prices were high and kept rising. Dhammika realized that until the cycle turned and gas prices dropped, RBCA's profits would remain low. To preserve cash for the company, he asked RBCA's BoD to stop paying dividends. Until then, RBCA had always paid the full $10/share dividend to its P-shareholders. The BoD considered Dhammika's request and approved it.

That decision did not go well with the P-shareholders. To prove to the P-shareholders that the BoD had their interests close to heart, RBCA published data on the share ownership of its directors. This data showed that each of RBCA's directors owned Pshares (together they owned a total of 100,000 Pshares), and none of the directors owned Cshares. Furthermore, the Pshares that the directors owned were a significant portion of the directors' total net worth; a drop in the value of the Pshares would significantly hurt the directors' personal finances. The directors promised that as long as they served as RBCA's directors they would not sell their Pshares nor buy Cshares. This pacified the P-shareholders' dissent.

Five years later: Dhammika's strategy proved successful. Gas prices remained high and sales of GGWs continued to suffer, yet RBCA was in better shape than its rivals because it stopped paying dividends. Five years after RBCA suspended dividend payments, it had emerged as the largest and most profitable GGW manufacturer. The industry, however, was still suffering and even RBCA was only making a profit of $10M per year, far below its historical profitability.

At this point RBCA was contacted by Even Bigger Corporation ("EBC"), which is also a Delaware corporation. EBC was interested acquiring RBCA. After extensive negotiations between the BoDs of the companies, EBC and RBCA agreed to a transaction that would result in EBC acquiring all of RBCA, in return for paying $99.99 per Pshare and 1 cent per Cshare, for a total price of $100M ("RBCA/EBC deal"). RBCA's BoD unanimously approved the RBCA/EBC deal.

A penny for your worthless shares: According to Delaware law and RBCA's certificate of incorporation, the RBCA/EBC deal required approval by majorities of both Cshares and Pshares. RBCA convened a shareholder meeting, and prior to the meeting provided all shareholders with: (1) a copy of the entire agreement between RBCA and EBC; (2) a letter from RBCA's lawyers explaining that the RBCA/EBC deal has been approved unanimously by RBCA's BoD and would become valid 60 days after a majority of Cshares and a majority of Pshares were voted to approve it (even if a minority of shareholders dissented); and (3) a statement from RBCA's BoD explaining how the share prices were determined.

According to the BoD's statement, after extensive negotiations it became clear that the highest price EBC would pay for RBCA was $100M. EBC didn't care how this amount was divided between Cshares and Pshares, and left it to RBCA's BoD to determine this. The BoD did the following calculations: First, if RBCA was dissolved and its assets were sold for $100M (the price EBC was offering), all of the assets would go to the P-shareholders, since each of the million Pshares was entitled to $50 + accumulated unpaid dividend (5 years x $10/year). Second, if RBCA was not dissolved and instead continued to operate with an annual profit of $10M/year (as was its most recent profit), and RBCA resumed payment of dividends, then P-shares would be entitled to all of the profits because each of the million shares has a $10/share dividend preference. As a result, the BoD's statement concluded, Cshares were essentially worthless. The BoD nonetheless decided to give C-shareholders 1 cent per share (i.e., 0.01% of the total value of the deal) because otherwise C-shareholders would have no incentive to vote in favor of the deal, and this would thwart the deal since their approval was required.

Eric sues: At the shareholder meeting, 80% of participating Pshares and 70% of participating Cshares voted to approve the deal. Eric, a C-shareholder, immediately sued RBCA and its directors to enjoin the deal because the BoD allegedly breached its fiduciary duties to C-shareholders by giving P-shareholders 99.99% of the deal's value. The parties conceded (and you do not need to address), the following points:

- Under Delaware law and RBCA's certificate of incorporation, the deal would be authorized if it was approved by a majority of the directors, by a majority of C-shares and by a majority of P-shares.
- There was no fault in the procedures of convening and voting at the BoD meeting and the SH meetings that approved the deal (including compliance with notice requirements, quorum requirements, and majority requirements).
- The BoD conducted competent negotiations with EBC, and there is no reason to believe that EBC or anyone else would pay more than $100M for RBCA.
- The BoD conducted adequate deliberation and had the appropriate expertise and information to determine how to divide the $100M between the shareholders.
- Eric has standing to sue and an injunction is an appropriate remedy under the circumstances, if he can successfully challenge the RBCA/EBC deal.

Meanwhile, in Urbana, Illinois: Though it has all the other amenities of a major metropolis, Urbana had never had its own stock exchange. USE Corp. ("USE"), a Delaware corporation, was founded to address this shortcoming and operate the Urbana Stock Exchange. Acquiring the technology to operate the stock exchange was easy; the problem was to attract well-known firms to list their shares on the Urbana Stock Exchange. To do this, USE decided to run an aggressive ad campaign. As part of this campaign, USE ran television commercials in which CEOs of large companies praised the Urbana Stock Exchange and said unflattering things about rival stock exchanges.

Rob is a foreman at one of RBCA's manufacturing lines. While Rob was on a week-long vacation from work, USE contacted him and asked if he would appear in one of their ads for $100,000. Rob agreed and the ad was produced during his vacation. In the ad, which was shown on many TV channels, Rob said: "As an employee of a company that is listed on the NYSE, I warn you not to make the same mistake. NYSE is a corrupt company; my company had to pay NYSE a million dollars in bribes so that they do not delist us. Learn from our mistake - list your company on the Urbana Stock Exchange." During this commercial, subtitles appeared identifying Rob as "Employee of RBCA".

Shame on you: RBCA's directors saw the USE commercial, and in RBCA's next BoD meeting they discussed it. The directors were upset that Rob did not ask their permission to participate in the commercial, despite the fact that Rob's employment contract prohibited him from participating in commercials unless he received prior approval from the BoD and required him to follow any conditions the BoD may make in giving such approval, regarding what he says or doesn't say in the commercial. The BoD summoned Rob, reprimanded him for not asking permission, and offered to settle the matter if Rob would pay RBCA half of the compensation he received for the commercial. Rob apologized for forgetting to receive BoD approval, told the BoD that he received $100,000 for the commercial, and promptly paid RBCA $50,000 to settle the matter.

A few days later, NYSE sued Rob and RBCA for defamation due to Rob's statement in the commercial, that NYSE demanded bribes from RBCA. RBCA acknowledged that NYSE did not demand any bribes from RBCA, but denied that RBCA is liable for Rob's statement. Assume that under tort law of defamation, Rob is liable to NYSE.

Discuss: (a) Eric's suit to enjoin the RBCA/EBC deal; and (b) RBCA's liability to NYSE.

Question 2

Note: The effective date for this question is **Dec. 1, 2009**. In answering this question, please disregard any real world information that came out after the effective date.

From: Ben I. Graham [mailto:Mr.BIG@work.com]
Sent: Wednesday, Dec. 9, 2009 9:00 AM
Subject: Wendy's/Arby's Group, Inc.

The Board of Directors of the Wendy's/Arby's Group, Inc. (NYSE: WEN) retained us to advise it regarding a transaction they are considering. I have to deal with another matter and so I leave it to you to write them a memo advising them.

WEN is interested in acquiring control in Renée's Gourmet Foods ("RGF"), a Canadian manufacturer of premium chilled salad dressings, sauces, dips, marinades and mayonnaise. RGF was acquired in 2006 by the H. J. Heinz Company (NYSE: HNZ), and it is currently a subsidiary of HNZ.

WEN believes that there are significant synergies in including RGF products in the offerings of Wendy's and Arby's restaurants. Such products can help differentiate Wendy's and Arby's from their competition, while at the same time enhance the marketing of RGF products, which restaurant patrons may later buy for use at home.

To lower the cost to WEN while maintaining control of RGF, WEN intends to bring in another company, Legg Mason Inc. (NYSE: LM) as a minority investor. The plan is for WEN to own 51% of RGF, and for LM to own the remaining 49%. Because WEN receives control of RGF, WEN expects to pay more than 51% of the purchase price. WEN and LM need to negotiate the precise division of costs; WEN expects to pay about 60% of the price that will be negotiated with HNZ.

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. WEN is going to use your memo as the blueprint for addressing this transaction, 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 analysis, but if you need additional information that is not available publicly, let me know exactly what you need and I will ask WEN to provide us with answers.

Thanks!

Business Associations I – Fall 2009
Answer to Question 1

I. **Eric's suit to enjoin the RBCA/EBC deal**

Challenged action: BoD decision that CSHs receive only 0.01% of merger's payout.

1. **BJR** - Authority is conceded, but Eric alleges a breach of fiduciary duties. Does BJR shield the BoD's decision? The BoD made an affirmative decision, and Eric concedes that it is a business judgment (BoD made adequate efforts to get best deal from EBC, had the required expertise and information to determine how to divide the $100M between SHs, and deliberated sufficiently on how to do this). Did directors act in bad faith? No illegality of corporate waste ($100M compensation to corporation as a whole is adequate). But there is a conflict of interest - the Pshares the directors owned were a significant portion of the directors' total net worth, and they owned no Cshares. All directors are tainted by CoI, and the BJR is rebutted.

2. **Breach** – When BJR is rebutted and plaintiffs allege a conflict of interest, court conducts substantive review to determine fairness (*Bayer*). Here, paying 1¢/Cshare is probably unfair because of the transaction's timing relative to the GGW business cycle. Currently, with gas prices high and profits low, RBCA's value and profits are sufficiently low that Pshares have priority to RBCA's entire value. But GGWs are a cyclical industry, and when gas prices go down (5-10 years, and 5 years have already passed) RBCA's profits and value will increase. All of this increased value would accrue to C-shareholders if they remained SHs, but under the RBCA/EBC deal they would be forced out now.

3. **Ratification** – approval by 70% of Cshares is arguably ratification, but this requires disclosure of all material facts. Here, SHs not told about GGW business cycle or RBCA's expected future profits. This is likely material – reasonable SH would find it relevant to deciding whether to approve the deal. Therefore, ratification was not fully informed, and is invalid. Also, evidence of directors' share ownership – which is certainly material – is dated (disclosed 5 years ago) and has not been re-disclosed or referenced ahead of the SH vote.[1]

Effect of ratification: if ratification is informed and therefore valid, court may only consider if deal was corporate waste (since CoI was of directors, not controlling SH)

Result: Deal likely to be enjoined.

[1] In addition, a recent case that we did not study, *Gantler v. Stephens* (Del. 2009) stated that a SH vote that is required to approve an action cannot be considered a ratification. Since this case was not in the course material, this point was not expected in your answers.

II. **<u>RBCA's liability to NYSE</u>**

1. **<u>Rest. 7.07 – agency & employee status</u>**: Rob is an agent of RBCA because he acts (as an employee) on RBCA's behalf and subject to RBCA's control (Rest. 1.01). As a foreman he likely must follow instructions of higher-ranked officers & BoD, including about the manner & means of performing his work (Rest. 7.07(3)(a)), so he is an employee under *Butler*. Even under narrower rule in *Vandemark* Rob is likely an employee, since his employment agreement subjected him to BoD's instructions regarding his participation in commercials (the instrumentality of the harm to NYSE).
2. **<u>Rest. 7.07 – scope of employment</u>**: Under the purpose test (Rest. 7.07(2)) it is difficult to see how Rob intended to serve a purpose of RBCA in participating in the commercial. Rather, it seems that he had the personal motivation of earning money during his vacation. Under the foreseeability test (*Bushey*) it may be foreseeable that an employee would participate in commercials and would say something harmful to the company (that's probably why the employment agreement required BoD permission), but the conduct must relate to the employment, whereas here it seems that the motivation was personal (earning money). Therefore, RBCA is likely not liable under Rest. 7.07.
3. **<u>Rest. 7.08</u>** – In this case, actions taken by the agent, arguably with apparent authority (speaking as an RBCA employee), constitute the tort (defaming NYSE). But is there apparent authority when a foreman represents the company's interactions with a stock exchange? This would be credible information coming from the CEO or CFO, but less so coming from a lower-ranked employee who works on a production line. So RBCA is likely not liable under Rest. 7.08.
4. **<u>Direct liability</u>**:
    a. **Rest 7.05 – P's negligence**: An argument that RBCA is directly liable due to its negligence in selecting, supervising or controlling agent will likely fail: Rob was on vacation when he was contacted and when he performed on the commercial, and given his junior position in RBCA, the reasonable standard of monitoring during vacation would likely be very low.
    b. **Rest. 7.04 – ratification**: Under Rest. 7.04, P is liable for actions of A, if A acted with actual authority or P ratified A's conduct. There was no actual authority, but there was arguably ratification in the BoD's agreement with Rob to receive half of Rob's compensation for the commercial. Alternatively, there was arguably ratification in that "RBCA's directors saw the USE commercial", and made no immediate public announcement denying what Rob said, even though they later acknowledged that Rob's statement was false. RBCA's silence while knowing an employee publicly made a false statement regarding the company may be seen as sufficient endorsement to constitute ratification. Ratification requires full disclosure (BoD saw the commercial and knew about their relationship with NYSE, so they had all required information), and can only apply to actions done purportedly on behalf of the principal (here, Rob purportedly acted on behalf of RBCA, as RBCA's employee).

Therefore, RBCA is directly liable to NYSE because BoD ratified Rob's actions.