

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

**Business Associations 1**

Professor Amitai Aviram

Fall Semester 2010

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: Nov. 29, Nov. 30, Dec. 1, or Dec. 2. You must submit the exam, by e-mail to Tina Lamb (tinalamb@law.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 Delaware corporate law.
  - 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**

Extravaganza Corp. (“Extravaganza”) is a Delaware corporation that produces upscale entertainment events. Prima Donna (“Donna”) has been Extravaganza’s CEO and one of its seven directors for the past 15 years. While most of the other directors found Donna to be a bit cavalier about expenses, they highly respected her because she had turned Extravaganza from a minor player in the industry into an entertainment giant.

For years, Donna wanted Extravaganza to acquire Cutting Edge Theater, Inc. (“CET”), an avant-garde theater producer with modest financial success but much critical acclaim. However, CET’s CEO and sole shareholder Emma Nutt (“Nutt”) consistently refused to consider selling the company. Nonetheless, in case opportunity knocked, Donna prepared a written consent in which the BoD authorized her to negotiate a deal to acquire CET. All seven directors signed the written consent.

**New kid on the block:** Whenever a new director joined the BoD, Donna took him or her out to lunch at the most expensive restaurant in town to get to know them better and learn whether they have any skills or connections that can benefit Extravaganza’s business. This time, she dined with Kevin Witty (“Witty”), a theater professor and art critic who recently replaced a retiring director. Witty was unaware of the written consent mentioned above or even that Extravaganza was interested in acquiring CET.

Just as the waiters brought the caviar (in 24 karat gold bowls), Witty told a childhood story that implied that Nutt was a childhood friend of his. Donna told him that she would like Extravaganza to acquire CET, and that if Witty could persuade Nutt to sell, “Extravaganza would definitely make it worth your while.”

“Worth my while?” asked Witty.

“Extravaganza will pay you a fee of 2% of the deal,” Donna said, “but only if the deal closes.” Witty said he would try to persuade Nutt.

**The deal materializes:** Three weeks later, Donna received a call from Nutt. Nutt said that Witty has persuaded her to explore the possibility of selling CET to Extravaganza. Donna immediately flew to meet with Nutt, who demanded a hefty price of \$900M for CET. Donna decided that she could justify the price to the BoD, and signed a contract for Extravaganza to acquire CET (the “deal”). The deal was conditioned on Extravaganza’s BoD approving it.

Donna presented the deal to the BoD in the next board meeting. The directors agreed that an acquisition of this magnitude requires thorough study, and authorized hiring investment bankers and lawyers (“advisers”) to determine how much CET is worth to Extravaganza and whether the terms of the sale adequately protected Extravaganza’s interests. The advisers said they would need 10 days to do a thorough job, so the board scheduled a meeting two weeks later to discuss the advisers’ reports. The directors received the reports four days before the meeting to allow adequate time to read them.

Meanwhile, in a tragic accident, Witty fractured his foot while taking out the trash. While not life threatening, the injury prevented him from attending the next BoD meeting.

At the next BoD meeting, the directors (all six other than the injured Witty) discussed the advisers' reports and questioned the advisers. The investment bankers found that \$900M was a fair price. The lawyers recommended a few minor corrections to the contract (that did not affect the price). During the BoD meeting, Donna called Nutt and asked her to make the requested corrections in the contract, and Nutt agreed. The board then voted 6-0 to approve the deal. Neither Donna nor anyone else told the other five directors about Donna's promise to pay Witty.

A few weeks later, when Witty's foot healed, he paid a visit to Donna and inquired about the fee she promised, which amounted to \$18M (2% of \$900M). Donna promised that Extravaganza would pay Witty the \$18M within 60 days. The 60 day delay was necessary, Donna told Witty, because the company was short on cash right now due to the acquisition of CET, but in 60 days profits would replenish the treasury.

"Do I need to keep this a secret?" asked Witty. "You can tell anyone you want," responded Donna, "but do you really want to make people envious?"

**An inconvenient truth surfaces:** Witty told no one about the payment to avoid envy. However, a month later he received a questionnaire from Extravaganza's General Counsel's office. The questionnaire collected information that the General Counsel thought may need to be disclosed under security laws. Among the questions was one requesting disclosure of any money received by the director from Extravaganza. Witty disclosed the \$18M payment he was promised.

When the other directors learned about the payment Witty received, they were outraged. At the next BoD meeting, several of them demanded that Witty would waive the payment. Witty refused. One of the directors told Witty that if he collected the payment, the BoD would not put him on the ballot for re-election as director in the next elections.

Witty, sarcastically, held his hands as if he was balancing two sides of a scale. "Hmm... \$18M on this side... \$100K [his annual salary as director] on the other side... See 'ya!" And with that he left the board meeting.

After Witty left the directors turned their anger to Donna, claiming that she should not have promised him the payment. One director with financial expertise pointed out that the typical fee in such situations is around 0.1% of the transaction, not 2%. Donna conceded that the payment was excessive and that she got carried away in promising such a high fee, but said that "it was water under the bridge." A director argued that the BoD should vote on a resolution stating that the \$18M payment to Witty was unauthorized and therefore Witty cannot collect it. Donna said that this was a challenge to her authority, and that if the BoD approved this resolution, she would resign. This made the other directors back off, and the board meeting ended without any board actions related to Witty or to the payment.

A week later, the story about Witty's payment was leaked to the press. The Urbana Financial Times ran a front page story that argued that it was excessive to pay \$18M for one phone call that Witty made to Nutt to persuade her to negotiate with Donna.

Faced with such bad PR, the BoD authorized sending to the Urbana Financial Times an op-ed written by Donna that argued that Witty provided a great service to Extravaganza's shareholders in facilitating a deal that Extravaganza had long wanted to secure, and that a 2% fee was reasonable in these circumstances. The Urbana Financial Times published the op-ed.

The scandal, however, refused to disappear. After another two weeks of damaging press coverage, the BoD met and voted 5-1 to fire Donna from her position as CEO. Shortly after this, 60 days had elapsed and Witty tried to collect the payment from Extravaganza, but was refused. He sued Extravaganza to collect the \$18M. Extravaganza counter-sued Witty for breach of fiduciary duties. Both parties waived any claims of estoppel (so you should not discuss estoppel arguments). **Discuss the suit and counter-suit.**

## Question 2

Note: The effective date for this question is **Nov. 21, 2010**. In answering this question, please disregard any real world information that came out after the effective date.

**From:** Wendy I. Zeller [mailto:Ms.WIZ@work.com]

**Sent:** Wednesday, Nov. 21, 2010 9:00 AM

**Subject:** Dollar General Corporation

The Board of Directors of Dollar General Corporation (NYSE: DG) retained us to advise it regarding a transaction they are considering. I have to deal with other matters and so I leave it to you to write a memo advising them.

DG is interested in acquiring FAO Schwarz (“FAO”), a high-end toy retailer that is owned by Toys “R” Us, Inc. (“TRU”). The purchase price is currently being negotiated. Under the terms of the transaction, TRU will receive an option, valid for one year after closing the deal, to repurchase FAO at the purchase price plus 5%. During the term of the repurchase option, DG would not be allowed to draw any dividends from FAO or otherwise transfer assets from FAO to DG. TRU has made clear to DG that these terms are essential to the transaction and are non-negotiable.

TRU is currently not a public corporation, but it still files with the SEC as required by its debt agreements. TRU announced plans for an IPO (selling shares to the public and thus becoming a public corporation again). I have heard rumors that the IPO was planned because TRU needs to urgently raise money for certain expenditures. However, since the failure of an IPO by another company (Harrah's Entertainment Inc.) days ago, the success of TRU's IPO has been called into question and TRU is expected to postpone its IPO for a few months.

That's what I know about the transaction. Gather any other information you need from public sources. **I need you to prepare, by 10 am tomorrow, a memo explaining in detail what DG would need to do to facilitate this transaction while minimizing the likelihood that the transaction is successfully challenged in court.** DG 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.

Thanks!

## **Business Associations I – Fall 2010: Answer to Question 1**

1. **Witty's suit:** Witty alleges that Extravaganza is liable as principal for the \$18M payment that Donna promised on its behalf. He wins due to BoD's implied ratification of Donna's payment.

- (a) **Agency by agreement:** Yes. For Donna to be Extravaganza's agent by agreement, Extravaganza needs to assent that Donna act on its behalf and subject to its control (Rest. 1.01). As CEO, Donna acts on Extravaganza's behalf and subject to the BoD's control. In addition, the written consent instructed Donna to negotiate on behalf of Extravaganza, and subject to the BoD's approval.<sup>1</sup>
- (b) **Actual authority:** BoD authorized Donna to negotiate a deal to acquire CET.<sup>2</sup> Nothing was said about paying a fee for facilitating the transaction. Was authority to pay the fee implied from the authority to negotiate a deal? Under Rest. 3.01, actual authority requires that a BoD manifestation (written consent authorizing to negotiate) would make Donna reasonably believe she was authorized to pay a finder's fee. Using Witty to "break the ice" with Nutt is "necessary or incidental to achieving" the objective of acquiring CET (Rest. 2.02(1)). However, authority to offer 2% is likely unreasonable because the typical fee is 0.1%. No actual authority.
- (c) **Apparent authority:** Under Rest. 3.03, apparent authority is created by manifestation from P (Extravaganza's BoD) to T (Witty) that would reasonably cause T to believe that A (Donna) was authorized to offer the 2% fee. Witty was unaware of the written consent, so it cannot create apparent authority. He was aware that Donna was Extravaganza's CEO. 2% fee is 20 times more generous than the norm, but Witty is an art critic and not a financial expert, and having Extravaganza pay for a lavish meal in golden bowls may manifest Extravaganza's acquiescence to lavish spending. It's unreasonable, though, that the CEO would be authorized to pay \$18M for one phone call. Distinguishing *Lind*, this is a bigger payment for much less work. No apparent authority.
- (d) **Ratification:** Ratification retroactively creates actual authority (Rest. 4.02(1)). BoD could ratify through conduct that justifies a reasonable assumption that it consented to the deal (Rest. 4.01(2)(b)).
  - i. Appropriate ratifier: actor who can legally take the action – BoD can approve a 2% fee to Witty.
  - ii. Action ratifiable: Donna's promise to pay 2% likely exceeded her actual authority (see 1b), and was perhaps negligent (in offering so generous a pay), but both of these defects can be cured by ratification.<sup>3</sup>
  - iii. Ratification is unambiguous: First, Witty could understand the director's statement at that meeting as offering him to choose between receiving the

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<sup>1</sup> Even though Donna is a director, nothing in the fact pattern suggested that BoD created a BoD committee or that Donna purported to act as a BoD committee.

<sup>2</sup> Change in the composition of the BoD does not invalidate prior acts of the BoD. Therefore, adding Witty to the BoD did not invalidate the written consent.

<sup>3</sup> Rest. 4.02(2)(b) is irrelevant, because it applies to ratification "in favor of an agent" – here, the agent is Donna, but the ratification is in favor of Witty.

payment (and not getting reelected) and returning the payment and getting reelected – thus allowing him to keep the payment if he accepted not being reelected. A single director cannot manifest the BoD’s views, but the fact that other directors remained silent may indicate acquiescing to this. Second, BoD’s conscious avoidance of passing a resolution declaring the payment unauthorized may be seen as acquiescing to the payment (BoD chose to accept the deal with Witty to prevent Donna from resigning). Third, BoD’s authorization of Donna’s op-ed that justifies the payment amounts to unambiguous consent.

iv. Ratification is informed: after Witty reported the payment in the questionnaire and the information was conveyed to the other directors, they were fully informed. Acts that caused ratification occurred after directors were informed.

(e) **Liability for Donna’s FD breach:** No need to analyze whether Donna’s approval of the payment breached FD, because third parties are liable for A’s breach of FD only if they knowingly participated in the breach. T’s acquisition of favorable terms through arm’s-length negotiations isn’t knowing participation (*Malpiede*). Here, Donna assures Witty that he doesn’t need to keep the payment secret, implying that there’s no breach.

2. **Extravaganza’s counter-suit:** Extravaganza alleges that Witty violated FD by failing to disclose to BoD his interest in the deal (2% payment he would receive if deal closes) before BoD approved the deal.<sup>4</sup> Witty breaches FD but wins due to BoD’s implied ratification of his breach.

(a) **Authority:** irrelevant (inaction).

(b) **Duty:** Witty owes FD to Extravaganza as a director.

(c) **BJR:** rebutted (inaction).

(d) **Breach:** FD is breached for failure to disclose if fiduciary had duty to disclose the information and if the information is material. A duty arises when the fiduciary has information relevant for another actor to act on behalf of the corporation. Here, BoD acts to approve the deal. Knowing about the generous payment promised to Witty (and the bad press that might arise when this payment becomes known) is material because a reasonable director would find it relevant in deciding whether to approve the deal. Therefore, Witty breached FD by not disclosing the fee.

(e) **Approval:** Consent is irrelevant (no info on AoI clause exculpating directors, and can’t exculpate from bad faith violation anyway under DGCL 102(b)(7)). No explicit ratification, but BoD ratified implicitly.

(i) Appropriate ratifier: actor who can legally take the action – BoD was to receive the proper disclosure and so can ratify faulty disclosure.

(ii) Action ratifiable: failure to disclose can be cured by ratification.

(iii) Ratification is unambiguous: Ratification here was implied, but it was unambiguous (see 1d(iii)).

(iv) Ratification is informed: yes (see 1d(iv)).

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<sup>4</sup> This isn’t a conflicted actor transaction because Witty did not vote to approve the deal, nor is it a benefit out of fiduciary position because the benefit was due to Witty’s acquaintance with Nutt, not his fiduciary position.