University of Illinois College of Law
Examination Cover Sheet

Business Associations 1
Professor Amitai Aviram
Fall Semester 2011
Number of Pages: 6 (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 (Room 324) between 9-10am on one of the following days: Dec. 7, 8, 9, 12.
    b. You must submit your response as a .doc or .docx (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. 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, Delaware corporate law RUPA, and U.S. securities 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 inform about any real person or event.

Question 1

The fact pattern of this exam loosely imports characters and some of the setting of the movie "The Hudsucker Proxy". Though that movie takes place in 1958, please answer the exam questions as if the events took place this year.

Prelude: At the meeting of the board of directors of Hudsucker Industries, Ltd.

Sheldon Stilson, director and Chief Financial Officer of Hudsucker Industries, Ltd. ("Hudsucker"; a Delaware corporation), concluded his presentation on Hudsucker's performance in the past year. "To summarize: while our widget operations continue to be profitable, the market for widgets is in decline. In order to diversify away from this declining industry, three years ago we opened a bond trading division that specializes in the value segment of the bond market – bonds that trade at irrationally low prices, which we buy and hold to maturity. This year our strategy was again vindicated. Our profits have increased by 10% over last year, making it the second consecutive year that our profits rise."

The board room filled with the sounds of enthusiastic claps. Waring Hudsucker, director and Chief Executive Officer ("CEO") of Hudsucker, put his cigar in the ashtray and stood up, prompting the directors to cease their clapping. Waring removed his wrist watch and placed it on the table. He climbed onto his plush chair, then stepped up to the long, rectangular, solid oak table. The heavyset man ran down the table, past the faces of the astonished directors, and leapt through the glass window at the other end of the table, falling 44 floors (45, counting the mezzanine) to his death.

The shocked directors turned to Sidney J. Mussburger, director and Chief Operating Officer ("COO") of Hudsucker and the #2 person in Hudsucker's hierarchy. Mussburger stood up. Something about Waring's surprising suicide concerned the cold-hearted executive. He turned pale as he realized what it was. "Mr. Stillson," he asked in a worried tone, "what is the market value of our bond portfolio?"

Treasure or trash?: Stilson flinched. "The market value, sir?"

"Yes, Stilson, the market value," Mussburger barked back. "At current market prices, how much is the bond portfolio worth?"

"That's hard to say, Mr. Mussburger. As a result of the recent financial turmoil, there is no market for most of the bonds we own. Nobody wants to buy them right now. That's why we are able to buy them so cheaply."

"Then how can you say that our profits rose?" asked another director.

"Shut up, Garnier," Mussburger growled at his fellow director. "You're breaking my line of thought." Turning to Stilson, he asked "then how can you say that our profits rose?"

"Our economists value the bonds we own based on our estimates of their true worth. Since we plan to hold the bonds to maturity rather than sell them on the market, and since the markets have been so irrational lately, we don't use market prices to calculate our profits. Instead, our economists make a few assumptions as to future economic conditions at the time the bonds are due, and then value the bonds according to those assumptions. Based on these valuations our profits are increasing, since we keep buying very promising bonds at ever lower prices."

Mussburger moved to the head of the table, plumping into Waring's vacant chair. He picked up Waring's still lit cigar and looked at it. "It's a good cigar. Shame to waste it," he muttered, taking a puff and ignoring the other three directors' shocked stares.

"OK," Mussburger continued after blowing some smoke, "here's what we do. First of all, you appoint me as CEO. Next, we need to raise some cash, so you need to authorize me to sell our bond portfolio and perhaps also our employees. Then-"

"Er… Mr. Mussburger, I beg your pardon but we can't sell our employees," said Stilson in a timid voice. "We don't own them. The Constitution's 13th amendment prohibits it. We can't sell them."

Mussburger returned an angry stare. "Are you a lawyer, Stilson? Didn't think so. Tell our legal department to take a look at this, see if there's a way around this 13th amendment."

He turned to face all of his fellow directors. "OK. So now you appoint me as CEO, give me authority to sell our bond portfolio and if possible our employees, and then get out of here and give me some time to think."

"Shouldn't we have a search committee to select our next CEO?" asked Garnier.

Garnier froze under Mussburger's angry stare. "No, Garnier. If you haven't noticed, we have a crisis in our hands, and we don't have time for a search. You have hereby appointed me CEO of Hudsucker and authorized me to sell our bond portfolio and employees. Now get lost, all of you." And with that, the meeting concluded.

Facing reality: Mussburger moved into the CEO's office that day, and began a detailed study of Hudsucker's financial situation. The situation was distressing. The widget division had \$10B in assets and produced an annual profit of about \$1B, though this market was in decline. The bond division had paid \$10B for its bond portfolio. The market for these bonds was very thin – buyers were rare, and those who did buy offered very low prices. Using the prices of the few transactions that took place, Hudsucker's bond portfolio was worth between \$5-8B. Hudsuckers' economists estimated that the portfolio was worth \$13B, but this valuation was based on an assumption that no more than 5% of the bonds would be in default. In reality, every one of the companies in Hudsucker's bond portfolio was in deep financial trouble and was at risk of defaulting within the next two years.

Now Mussburger discovered what likely triggered Waring's suicide. A letter from Hudsucker's accountants expressed concern about the discrepancy between the economists' valuation of the bonds ("mark-to-model" in financial terms) and the bonds' expected value according to market prices ("mark-to-market" in financial terms). The accountants threatened that they would not sign off on the company's next financial report unless the bond portfolio was marked-to-market (i.e., valued at about $5-8B).

Mussburger hired an investment bank to look for buyers for the bond portfolio. After an exhausting search, the best offer they got was $7B. If this offer was accepted, Hudsucker would have to report a $6B loss, reflecting the difference between the value that Hudsucker had claimed the bonds were worth ($13B) and the price for which it sold them ($7B). Mussburger ruled out that option.

Meet the Press: If the failed attempt to sell the bonds were not bad enough, the same day Mussburger learned that the legal department could not find a way to sell Hudsucker's employees. He was ready to call it a day and go home when his secretary told him that Amy Archer, a journalist from the Urbana Financial Times, was waiting outside his office and wanted to interview him. Mussburger could never say no to publicity.

The fast-talking journalist went straight to the point: "What changes should we expect in Hudsucker's strategy with you in charge?"

"You should expect immense profits. We're changing strategies and liquidating some investments." Suddenly an idea hit him. "Would you like to buy Hudsucker's bond portfolio, Ms. Archer?"

She took it surprisingly seriously. "How much money are we talking about?"

"Fifteen billion dollars."

Archer smiled. "I don't think I have this much money with me right now."

Mussburger was serious. "Hudsucker will lend you the money."

"And how will I pay it back if the bonds turn out to be worth less than what I owe?"

"Hudsucker will sell the bonds to a corporation you will own, and will lend your corporation the money to buy the bonds. If the bonds turn out to be worth more than the loan, you will pay back the loan and keep the remaining money. If the bonds turn out to be worth less, your company will default on the loan and go bankrupt, and you walk away without any personal liability."

"What's the catch?"

"Hudsucker wants to sell these bonds for $15B and record a big profit now."

"So why aren't you selling it to a company you control?"

"That would be dishonest, Ms. Archer. I want no conflict of interest on this transaction."

Archer said she would consult with a lawyer and get back with an answer the next day.

Deal!: Archer formed the Amy Archer Company ("Amarco"), a Delaware corporation. Archer was the sole shareholder and the sole director of Amarco. Archer (on behalf of Amarco) and Mussburger (on behalf of Hudsucker) then signed an agreement ("the deal") that included: (1) Amarco receiving a 30-year loan of $15B from Hudsucker at the going market interest rate, with the interest to be paid (together with the principal) only at the end of the loan's term; (2) Hudsucker selling its bond portfolio to Amarco for $15B. The deal was to close 10 days after it was signed, did not state that any approvals were required, and did not specify any contingencies that would allow a party to cancel it.

The next day, at Hudsucker's BoD meeting, Mussburger informed the other directors for the first time about the deal. A copy of the agreement was provided to the directors, and Mussburger explained that as a result of the deal, Hudsucker would record a profit of $2B ($15B minus the $13B that Hudsucker claimed as the bonds' value under "mark-to-model"). Together with the profit from the widget division, this was more than double last year's profit. Better yet, the bonds were no longer owned by Hudsucker, so the accountants won't bother Hudsucker again with demands to mark-to-market (the $15B loan was not due for 30 years and did not trade on the market, so the accountants did not require it to be marked-to-market).

The directors gave Mussburger a standing ovation for more than 5 minutes, including singing "For he's a jolly good fellow" several times. The board then resumed its meeting, discussing other matters. It did not discuss the deal again.

… Or no deal?: A week later, the Federal Reserve Bank announced that, as part of a plan to boost the economy and pull out of the recession, it would buy certain corporate bonds. Among those were the bonds in Hudsucker's portfolio. The market price of the portfolio rose sharply, to about $18B.

Two days later (i.e., 10 days after the agreement was signed), Archer contacted Mussburger to inquire why the bonds were not transferred to Amarco. She did not receive any reply and Hudsucker did not transfer the bonds to Amarco (nor lend Amarco $15B).

Amarco sued Hudsucker and Mussburger for breaching the deal. **Discuss this suit**.

Question 2

Note: The effective date for this question is **Nov. 30, 2011**. 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: Thursday, Dec. 1, 2011 9:00 AM
Subject: Commercial Metals Co.

The Board of Directors of Commercial Metals Company (NYSE: CMC) retained us to advise it regarding a transaction they are considering: selling its Americas Recycling Segment ("ARS") to PSC Metals, Inc. ("PSC", a closely-held corporation).

The transaction is a little complicated in terms of the compensation CMC will receive. The value of ARS will be determined, within 3 days after the agreement is signed, by an independent expert that will be specified in the agreement. Rather than paying this value in cash, PSC will pay up to $230 million of it in CMC common stock (i.e., the seller's stock) at a rate of $20 per share, regardless of the price that CMC's shares will actually trade for at that time. For example, if the independent expert determines the value of ARS is $200 million, then PSC will pay to CMC ten million CMC common shares.

If the independent expert determines that the value of ARS is over $230 million, PSC will pay the remainder in cash, borrowing the money from JPMorgan Chase & Co. (NYSE:JPM) at terms specified in the agreement. For example, if the independent expert determines the value of ARS is $250 million, then PSC will pay to CMC 11.5 million CMC common shares and $20 million in cash (which it will borrow from JPM).

As part of the agreement, PSC will promise (the "standstill clause") that for a period of 5 years neither it nor anyone who controls it or is controlled by it: (i) will acquire additional CMC shares other than shares that PSC will transfer to CMC to pay for ARS; and (ii) sell CMC shares to anyone other than CMC. If PSC breaches the standstill clause, it will pay to CMC liquidated damages of $100 million. PSC will pledge assets worth $150M as collateral to guarantee its obligations under the standstill clause.

These terms were agreed upon yesterday night by the CEOs of CMC and PSC and senior executives at JPM. One more thing I learned from talking to Joseph Alvarado (CMC's CEO): Rhys Best, one of CMC's directors, has been instrumental in putting this transaction together. When Mr. Best's contribution became apparent, Mr. Alvarado promised Mr. Best that CMC will pay him a fee of $200,000 if the transaction is signed.

I need you to prepare, by 10 am tomorrow, a memo to CMC's board that: (i) identifies any legal challenges that dissenting shareholders might raise to thwart the transaction; and (ii) explains what CMC needs to do to facilitate this transaction while minimizing the likelihood that dissenting shareholders successfully challenge the transaction in court. Gather any information you need from public sources.

Thanks!

BA1, Fall 2011: Answer to Question 1

Hudsucker is liable on the contract if either: (a) Mussburger was its agent by agreement and had either actual or apparent authority to sell the bond portfolio; or (b) Mussburger was its agent by estoppel.

1. **Existence of agency**: For Mussburger to be Hudsucker's agent by agreement, Hudsucker needs to assent that Mussburger act on its behalf and subject to its control (Rest. 1.01). Directors aren't a corporation's agents as such, but Mussburger was also either COO or CEO, and as such he fulfilled these conditions: acting on behalf of Hudsucker as a senior executive, and subject to the control of the BoD de jure, even if he dominated the BoD de facto.

2. **Actual authority**: Did BoD authorize Mussburger to sell the bond portfolio and finance the sale? Under Rest. 3.01, this would require a manifestation by Hudsucker's BoD that would make Mussburger reasonably believe he was authorized to sell the bond portfolio. If Mussburger was authorized to sell the bonds, he would likely have authority to finance the sale under Rest. 2.02(1), as incidental to the principal's objective of selling the bonds (it wasn't necessary, as the $7B alternative sale suggests, but financing allowed a sale at $15B).

BoD didn't act through written consent or vote,[1] but it didn't challenge Mussburger's multiple assertions that it authorized him to sell the bonds (except for Garnier's meek comment, which wasn't pursued), and it allowed Mussburger to move to the CEO's office and work with the legal department and investment bankers. A reasonable agent might consider directors' possible state of shock having just witnessed Waring's suicide, and directors seemed not so much to agree with Mussburger as to be bullied into silence. But the BoD stayed passive after the meeting, suggesting acquiescence rather than momentary shock or intimidation. Close call; I lean towards finding no actual authority.

3. **Apparent authority**: Under Rest. 3.03, apparent authority is created by manifestation from P (Hudsucker's BoD) to T (Amarco) that would reasonably cause T to believe that A (Mussburger) was authorized. No indication that Amarco knew of the events at the BoD meeting, but Archer met Mussburger in the CEO's office, which is under the BoD's control, so Amarco could reasonably believe that Mussburger had any authority a CEO reasonably would. It would be unreasonable, however, to expect even the CEO to have authority to sell and finance what amounts to at least 60% of Hudsucker's assets ($15B out of $15-25B, depending on the value of the bond portfolio) – such a large transaction would reasonably require BoD approval. Therefore, no apparent authority.[2]

[1] The lack of formal action by the BoD is not dispositive, because the analysis depends on the principal's manifestations, not just its (formal) actions. The lack of a vote or written consent may weaken an agent's actual or reasonable belief that the principal authorizes her to act in a particular way, but other manifestations may also affect the agent's actual and reasonable belief. Also note that our analysis of the BoD's acquiescence to Mussburger at the first meeting and between the first and second meetings revolves around the existence of actual authority to sell the bonds (Rest. 2.01), not around ratification (Rest. 4.01); until the second meeting, the deal was not yet signed and brought to the BoD's knowledge, so it could not be ratified.

[2] Some student answers questioned the reasonableness of Amarco's belief based on the deal being too good to be true (Amarco's potential for a huge gain without incurring any risk). Whether this is correct depends on how it is presented. A third party does not need to question a deal just because it is very good to it or

4. **Ratification**: If BoD ratified the deal by applauding it, actual authority was retroactively created (Rest. 4.02(1)).

(a) Appropriate ratifier: BoD has authority to sell assets of the corporation and lend its money (DGCL 141(a)),[3] so BoD can ratify.
(b) Action ratifiable: Deal's potential legal flaw is lack of authority, which makes it voidable and thus ratifiable. If deal amounted to corporate waste, it was void and unratifiable. But corporate waste requires that no one could conclude corporation received adequate consideration – here, corporation receives something from the deal (removing the bonds from its balance sheet and higher sale price).
(c) Unambiguous: BoD could ratify through conduct that justifies a reasonable assumption that it consented to the deal (Rest. 4.01(2)(b)). Here, a five-minute standing ovation suggests BoD consented to the deal (cf. *Tyco*). BoD was bullied by Mussburger in the past, but this time provided a voluntary and enthusiastic, rather than meek and passive, response.
(d) Informed: BoD sees the agreement and knows from previous meeting about bond valuation concerns, but isn't informed about alternatives to the deal ($7B sale with no financing), nor about the risk of lending to Amarco (which has no assets other than the bonds). Both are likely material; therefore no ratification.

5. **Estoppel**: Because the deal was purportedly done on its account, under Rest. 2.05 Hudsucker is estopped from denying it's bound by it if:

(a) Amarco was justifiably induced: Likely not justifiable; Amarco should know that even a CEO doesn't have sole authority to sell or lend over 60% of Hudsucker's assets.
(b) Amarco made a detrimental change in position: Likely no. Amarco received all of the money for the purchase from Hudsucker, so no finance charges and no lost opportunity to invest its money. Legal fees to create Amarco may be considered detrimental change, but seem negligible.
(c) Hudsucker intentionally or carelessly caused Amarco to believe Mussburger was authorized, or having notice of such belief and that it might induce Amarco to change its position, Hudsucker didn't take reasonable remedial steps. Here, BoD's acquiescence to Mussburger's seizing of the CEO office & claim of authority to sell the bonds likely amounts to intentional or careless causing of Amarco's belief; at least, BoD had notice Mussburger might try to sell the portfolio, and BoD didn't act to inform third parties he wasn't authorized.

Because facts fail first two prongs of the test, likely no estoppel.[4]

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very bad to the principal; principals can't disclaim authority retroactively because their agents made bad deals. However, some exceedingly sweet deals may be perks that the principal would reasonably be expected to maintain sole authority to distribute (e.g., a commission on subordinates' sales, as in *Lind*), or are so significant to the principal that it would not delegate them to an agent (e.g., perhaps financing a sale of this scope). The extreme sweetness of the deal would then provide facts bearing on the legal test of whether it is reasonable that a principal authorized its agent to offer the deal.

[3] The sale was not subject to DGCL §271's requirement of a SH vote, because it was not a sale of "all or substantially all" of the corporation's assets. Since this section was not assigned and was only mentioned in passing, you were not expected to raise this issue.

6. **<u>Mussburger's liability</u>**

Under Rest. 6.01(2), if A, acting with authority, makes a contract with T, then A isn't a party to the contract unless agreed otherwise.[5] But this shields Mussburger from liability only if:

(i) BoD gave Mussburger actual authority (likely not, see 2);

(ii) Amarco reasonably believed a CEO was authorized to bind Hudsucker to the deal, creating apparent authority (likely not, see 3); or

(iii) BoD's applause is deemed a ratification of the deal (likely not, see 4).

If Mussburger acted without authority, then in purporting to make a contract on behalf of Hudsucker he gave an implied warranty of authority (Rest. 6.10). He is liable to Amarco for its breach unless:

(i) Hudsucker ratified the deal (likely not, see 4);

(ii) Mussburger disclaimed the warranty (fact pattern does not suggest this); or

(iii) Amarco knew that Mussburger lacked authority (in 3 we found that Amarco reasonably should have known this, but there's no evidence if it actually knew).

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[4] Estoppel is an alternative to agency by agreement, but it is not preempted if agency by agreement exists. If the facts allow it, Hudsucker could be liable under both an agency by agreement and an estoppel argument.

[5] Piercing the corporate veil is irrelevant here, since it imposes liability on shareholders for a corporation's obligations. The fact pattern does not suggest that Mussburger is a shareholder, nor is there any suggestion that he acted in ways that trigger PCV (e.g., tunneling, undercapitalizing).