University of Illinois College of Law
Examination Cover Sheet

Business Associations 1
Professor Amitai Aviram
Fall Semester 2012
Number of Pages: 3 (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: December 12, 13, 14, 17.
   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. 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.

A spiffy idea: Spiffy Corp. ("Spiffy"), a Delaware corporation, is a publicly-traded company that offers subscribers fashion suggestions tailored to both their appearance (as analyzed by Spiffy's computers based on pictures the subscriber uploads) and lifestyle (based on Spiffy's tracking of subscribers' e-mails, social network profiles and web browsing habits). Spiffy earns money from advertisements to subscribers and from selling to other businesses the data it collected on its subscribers.

Steve Spruce ("Spruce") is Spiffy's CEO. Spruce is a Silicon Valley celebrity, known for his sense of fashion as well as thoughtful commentary on all things digital. His Facebook page is followed by thousands of people. Spruce explained in an interview to the Wall Street Journal that he uses his Facebook page "as a PR tool for Spiffy."

While Spiffy's bylaws do not specify the authority of its officers, a BoD resolution delegated to the CEO the "day-to-day management of Spiffy, including: […] all communications with the public, except for financial information (such as the company's sales, profits, expenses, etc.)." The same resolution delegates to the CFO, among other things, "communications with the public regarding financial information (such as the company's sales, profits, expenses, etc.), after consulting with the General Counsel and the CEO." The resolution also defines roles for a Chief Communications Officer, which include "monitoring the media to track Spiffy employees' communications with the public" and "preparing a report to the board of directors ahead of each monthly board meeting ("the CCO report"), with an evaluation of the impact of employee communications on Spiffy's public relations. The CCO report will also note any events in which employees violated Spiffy's communications policies."

This BoD resolution was not filed publicly, but was known to all directors and employees of Spiffy. The CCO reports occasionally identified employees who violated communications policies (such as Tweeting competitively sensitive information). The board always decided that the infractions in the reports were not sufficiently serious to warrant discipline, though it gave employees a warning upon committing their fifth infraction. Spruce was never cited in a CCO report as violating communications policies.

Facebook's financial scoops: In addition to his position at Spiffy, Spruce is also one of the directors of Facebook, and owns many Facebook shares. At a Facebook BoD meeting that Spruce attended, the directors were discussing ways to appeal to new customers. One untapped group of customers that seemed promising was the financial industry. A director suggested that if Facebook could get people to post financial and other business-related information as a "Facebook scoop" before it was available publicly elsewhere, Facebook could create a service that collected and sold this information to hedge funds and other financial players a few seconds before the rest of the public could see the post (so they can profitably trade on the news). Another director, who was a lawyer, said that positing financial information of a public company as a "Facebook scoop" might violate Federal securities laws. The directors agreed to instruct the General Counsel of Facebook to determine the legality of "Facebook financial scoops". If it turned out to be legal, said a director who was a marketing expert, it would only take a few conspicuous scoops to set a trend that others will follow.

<u>Sharing the good news… and getting some bad news</u>: A few days after the Facebook BoD meeting, on a Sunday morning, Spruce was at home writing a Facebook post when he received a call from Daphne Dapper ("Dapper"), Spiffy's CFO. Dapper told Spruce that as of that morning Spiffy's sales for the year exceeded $100M – for the first time in the company's history. She had prepared a press release that was already approved by Spiffy's General Counsel, and had e-mailed a copy to Spruce. Dapper told Spruce she will issue the press release on Monday afternoon (i.e., the next day), and asked him to let her know before then if he had any comments on the release.

Spruce was so elated that the minute he got off the phone with Dapper he fired off a Facebook post saying: "As of this morning, Spiffy's sales exceeded $100M for the year!!! Kudos to our devoted employees and thank you to our loyal subscribers!"

Dapper issued the press release on Monday afternoon. However, Spiffy's share price soared in Monday morning trading by investors who saw the good news regarding Spiffy's sales on Spruce's Facebook post.

That evening a lawyer from the Securities and Exchange Commission ("SEC") contacted Spruce and told him that the SEC was opening an investigation about his Facebook post, which it viewed as a potential violation of Federal securities laws because the Facebook post gave investors who follow Spruce's Facebook page an unfair advantage over investors who follow regular news sources or EDGAR (the SEC's database in which public companies file, among other things, their press releases so they're available to the public).

<u>Spiffy sued… and again…</u>: When news of the SEC investigation became public, Spiffy (but not its directors) was sued by Alex, a Spiffy shareholder who had purchased more Spiffy shares on Monday afternoon after seeing on EDGAR Dapper's press release about Spiffy's sales. Alex contended that Spruce's post put him at a disadvantage relative to investors who followed Facebook, and as a result the latter investors bought Spiffy shares more cheaply on Monday morning, while Alex had to pay a higher price by Monday afternoon. Assume that under Federal securities laws, Spruce is liable to Alex in torts for the Facebook post.

To avoid further embarrassment and legal expenses, Spiffy and Spruce quickly settled the SEC investigation, admitting that Spruce's Facebook post violated federal Securities laws and agreeing to pay a fine of $10M to the SEC.

Spiffy's directors were then sued derivatively by Beth, a Spiffy SH (who did not buy or sell any shares around the time of the Facebook post), for not preventing the Facebook post.

Discuss Alex's suit and Beth's suit.

Model answer for Fall 2012 BA1 exam:

1. **Alex's suit**

Spiffy is sued as a principal liable for the tort of its agent, Spruce.[1] Fact pattern assumes Spruce is liable to Alex in torts.

a. Is Spruce Spiffy's agent? Yes. As required under Rest. 1.01, Spruce acts on Spiffy's behalf as its CEO; and is subject to Spiffy's control (e.g., the BoD resolution specifying his authority).[2]

b. Direct liability - Actual authority (Rest. 7.04): Spruce's actual authority specifically excluded communicating financial information.[3] While disclosing financial information may be "incidental" to day to day management and to communicating with the public, which would normally imply actual authority under Rest. 2.02(1), and while Spruce may know that BoD is lax in disciplining employees' unauthorized public communications, the specific exclusion of financial information in the BoD resolution makes it unreasonable for Spruce to believe that he's authorized to communicate financial information (the test in Rest. 2.01).

c. Direct liability - Negligence (Rest. 7.05): Spiffy would be directly liable to Alex under Rest. 7.05(1) for negligence in hiring/retaining/controlling Spruce, if it knew/should have known that Spruce's employment put him in position where his unfitness creates foreseeable danger to others (*MacDonald*) – no indicator of unfitness here, since Spruce was never cited before in COO reports. Spiffy also doesn't have a special relationship with Alex[4] that is recognized in *Iseberg*, so no liability under Rest. 7.05(2).

d. Spiffy is likely vicariously liable because Spruce was an employee and his tort was likely conducted within SoE (Rest. 7.07).

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[1] Though Alex is a SH, his lawsuit is as a third party, since only Spiffy is sued (rather than also Spiffy's agents or organs) and the alleged wrongdoing is tortuous (under assumed federal law liability) and is not derived from a breach of FD. Therefore it was not appropriate to use the "insider framework", which analyzes claims a firm (or a SH acting for a firm) assets against its organs or agents.

[2] It is not enough to say that Spruce is an agent because he is an officer; your analysis needs to show how Spruce (as CEO) fulfills the conditions of Rest. §1.01.

[3] Direct liability for ratification was not an issue because I think the facts did not present behavior that can be interpreted as ratification. The short time between the post and the SEC reaction did not allow a conclusion that the BoD knew and acquiesced to the post, and settling the SEC charges (including admitting wrongdoing) is more reasonably interpreted as mitigating legal risks from the SEC than as embracing the illegal behavior or accepting its benefits (if any). However, exam answers that made these points were not wrong, and while this argument did not get issue points, it did have a positive effect on the general evaluation score. In contrast, arguing that the BoD's lax attitude towards past CCO reports was ratification of Spruce's behavior was a wrong answer (and had a negative impact on the general evaluation score), since BoD was not aware then of Spruce's financial post (which had yet to occur).

[4] The special relationship needs to be with Alex (the third party), not with Spruce (the agent).

1. Employee: Yes. Under Rest. 7.07(3)(a), Spruce is an employee because the BoD has the right to control the manner and means of his performance of work – though he has some autonomy as CEO, he must follow the BoD's instructions even if they micromanage him (as they did in the BoD resolution, specifying process for communicating financial information).
2. SoE: Likely yes. Contra to the positive test in Rest. 7.07(2), communicating financial information wasn't work assigned by the employer, and Spruce committed the tort from home on the weekend – the situation least subject to the employer's control (though as CEO he may be at BoD's disposal at all times). However, Spruce communicated on Facebook for the purpose of serving Spiffy (he said it was "a PR tool for Spiffy", and post also cultivates employee and client goodwill), so under the purpose test (*Patterson* & negative test in Rest. 7.07(2)) the tort was within SoE.

   An exception to the purpose test is when the agent acts with a personal motive. If Spruce's Facebook post was intended to start a trend of Facebook financial scoops, this would benefit Spruce personally as a Facebook director and SH, so the tort won't be within SoE. Likewise the post would be out of SoE if it was a spontaneous, excited reaction to the news that wasn't intended to serve Spiffy.

e. Spiffy is vicariously liable if actions its agent took with apparent authority constitute the tort (Rest. 7.08). Borderline case. Spruce is an agent (see 1a). The Facebook post that constituted the tort was taken with apparent authority: Spiffy manifested that Spruce was its CEO, and a reasonable investor would believe that CEOs can communicate financial information to the public (the financial information exception was in a non-public BoD resolution, so investors don't know about it). The Facebook post seems to also satisfy Rest. 7.08's requirement that the agent commit a tort "in… communicating with a third party purportedly on behalf of the principal". Yet the tort was not committed against those who read the post and considered Spruce's apparent authority, but against those who didn't (like Alex). This is different from the typical Rest. 7.08 cases that involve misrepresentation. A literal reading of Rest. 7.08 nonetheless finds Spiffy liable.

<u>2. Beth's suit</u>

a. Beth sues Spiffy's directors for failing to monitor Spruce and prevent his Facebook post, which can be characterized as either negligence or conscious disregard for duties.[5] Authority is irrelevant since Beth challenges an inaction. No facts suggest approval (other than 102(b)(7) exculpation; see 2c below), so only FD analysis is relevant. Defendants owe FD as directors. Fact pattern does not suggest directors have CoI in failing to monitor Spruce, so BJR SoR applies. The BJR is rebutted because the challenge applies to an inaction.

[5] There was no need to discuss Beth's ability to sue derivatively, since that was an incidental aspect of the *Beam* case that I specifically said would not be part of the BA1 material. All I expected you to know for BA1 about derivative suits is that they pursue a cause of action that belongs to the firm, and require you to apply the "insider framework".

b. Bad faith: No. Under *Stone*, failure to act amounts to bad faith only if either
    1. Directors "utterly failed to implement any" controls – here, directors relied on CCO reports. The reports couldn't prevent violations such as the Facebook post, but they allowed directors to punish repeat offenders if they chose to. This prong requires "any" control, not just a control that would have prevented the alleged harm.
    2. Directors "consciously failed to monitor" the controls, "disabling themselves from being informed of risks… requiring their attention" –Directors received reports from the Chief Communications Officer. While they were lenient to violators (so perhaps not effective in deterring violations), they were informed of the risks, as required by this prong.

c. Negligence: Spiffy is assumed to have limited director FD in AoI to maximum degree allowed under DGCL 102(b)(7), so directors aren't liable for unintentional negligence. If directors weren't exculpated, analysis would be similar to 1c (above), except that standard would be gross negligence (*McPadden*), which requires "reckless indifference", rather than ordinary negligence.