University of Illinois College of Law
Examination Cover Sheet

Business Associations
Professor Amitai Aviram
Fall Semester 2016
Number of Pages: 4 (including this page)
Time Allotted: Until 10am on the day following the day you received the exam
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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. Notify my assistant immediately (within 1 hour) if you did not receive by e-mail a copy of the exam by 10am on the day you selected (or on the default date, if you did not select an exam date).
   b. You must submit your response as a .doc/.docx (Microsoft Word) file e-mailed to my assistant 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**: 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. Students enrolled in this course are not allowed to solicit or receive information about the exam if the source of the information (directly or indirectly) is a person who has seen the exam.
5. **Length limit**: The total length of your answer may not exceed 1,000 words. For every 10 words in excess of the length limit (rounded up), one point will be taken off the exam's raw score.
6. **Answering the exam**: Cite relevant case and statutory authority. Subject to 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.
7. **Assumptions**: Unless the exam question specifies otherwise, assume that -
   a. The relevant jurisdiction applies the Restatement (Third) on Agency, Delaware corporate law, RUPA, and U.S. securities law.
   b. Each corporation's charter states that: the corporation is a stock corporation, has limited liability and perpetual existence; the corporation may conduct any lawful act or activity; director fiduciary duty is limited to & director/agent right to indemnification is extended to the maximum degree allowed under DGCL §102(b)(7) ; the board may amend the bylaws.
   c. Each corporation's bylaws state that: the chairperson of the board is authorized to call a board meeting; and the board is authorized to call both annual & special shareholder meetings.
8. **"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.

Sardine Corp. ("Sardine") is a closely-held Delaware corporation involved in the production of canned fish. Its founder, Sam Sardine ("Sam"), is the CEO of Sardine. Sam's older child, Shelly Sardine ("Shelly"), is the CFO of Sardine. Sam's younger child, Stuart Sardine ("Stuart") used to be the COO of Sardine, but was recently removed from that position due to a family conflict. Until recently, Sam owned 60% of Sardine's shares, while Shelly and Stuart each owned 20%, and all three were directors in Sardine's three-person board.

The roots of the family conflict lie in Sam's habit of borrowing money from Sardine to pay for an extravagant lifestyle. Sam paid the firm an interest rate that was equal to the rate the firm paid for money it borrowed (so the firm neither earned a profit nor lost from lending the money to Sam). However, by lending to Sam the firm used up funds that otherwise could be used to expand Sardine's business. Stuart often objected to his father's borrowing and urged that Sardine should expand its business. Shelly sided with Sam, saying that he (Sam) created the company, he's responsible for its profits and success, and that Stuart should not use Sam's generosity in giving Stuart (and Shelly) 20% of the shares and a board position to constrain Sam's enjoying the fruits of his success.

After years of clashes over this issue (which always ended in a 2-to-1 board vote, with Shelly supporting Sam), Sam had the board remove Stuart from his position as COO, because he couldn't work with him anymore. Stuart remained a director of Sardine, and continued to advocate at board meetings for freeing up money to expand the business.

Finally, Sam offered Stuart a compromise: Sardine would raise money by doubling the number of outstanding shares, issuing most of the new shares to a private equity firm called Perpetual Excellence ("PE"). It would issue the remaining new shares (amounting to 1% of shares outstanding) to Sam, so that the Sardine family members maintain a majority of voting power. Thus, after the share issuance Sam would have 31% of the shares, Shelly and Stuart would have 10% each, and PE would have 49%. The money raised from selling the new shares would be used to expand Sardine's business. This plan was approved by Sardine's board of directors, and after the new shares were issues, the board was expanded to five directors. Two new directors were added, Patricia and Ellen (both of whom were senior officers in PE). Patricia was made the chairwoman of the board.

When Patricia and Ellen became aware of the money Sam borrowed from Sardine, they expressed their displeasure that he was tying up firm resources for his own use. After several months in which Sam brushed away their criticism, Patricia warned Sam at a board meeting that the company could terminate the loan and demand repayment at any time. Shelly came to Sam's support, saying that as CFO she knew that the company had all the cash it needed right now, and there was no reason to recall the loan to Sam. Stuart stayed quiet, and eventually the board moved to discuss other issues.

After the meeting, Stuart met privately with Sam and told him that while he didn't want to embarrass his father at the meeting, he thought Patricia was absolutely right, and he urged Sam to do something about the loan immediately.

Sam now saw that a majority of the directors were willing to recall the loan. He did not have the money to repay it. And he could not replace Stuart as director, since without Stuart's shares, the Sardine family did not have a majority of the votes. Sam decided to borrow money from another source, and use the money to repay the loan from Sardine.

Sam contacted First National Bank ("FNB"), which was the bank Sardine used for financial services. FNB was willing to lend him the money, but only at a high interest rate reflecting his limited creditworthiness. Sam's lifestyle would be very constrained if he had to pay this much in interest. He asked what interest he would need to pay if Sardine guaranteed the loan. FNB checked Sardine's creditworthiness and offered a loan at a much lower interest rate (the same rate that Sam had been paying Sardine). Sam expressed interest in this loan, and FNB said they would prepare the documents.

Sam then went to a regularly scheduled Sardine board meeting. At the meeting, he told the other directors he planned to repay his loans to Sardine by the end of that week, by taking a loan from FNB. He asked for the board's blessing for the transaction (Sam did not give any other details about the transaction). All four other directors said that they were happy the issue was being resolved, and gave their blessing to the transaction.

After the meeting, Sam checked Sardine's bylaws to see whether he had authority to make Sardine guarantee the loan from FNB. The bylaw describing the office of the CEO stated that "the CEO has authority to manage the day-to-day business of Sardine, subject to any instructions from the board". He also looked for anything in the bylaws discussing authority to make the firm guarantee an obligation. The only relevant bylaw was the one describing the authority of the CFO, which stated (among other things) that "the CFO has authority to guarantee obligations of third parties, after receiving the approval of the board to do so." Sam rationalized that guaranteeing an obligation is part of the day-to-day business of the firm, and that as the CFO's boss he had all the powers of the CFO, including making the firm guarantee an obligation.

The next day he went to FNB, and signed the deal, both as the borrower and – on behalf of Sardine – as the guarantor. The FNB banker asked him whether he had authority to sign this on Sardine's behalf. Sam replied that he had checked the bylaws and found that as CEO, he has that authority. The banker hesitated, and went to check with a senior banker. The senior banker called Ellen, who he knew was a director of Sardine, and asked her if she knew about the loan the bank was to give Sam and if the company "was OK with it". Ellen said she knew about the transaction, and that they were quite happy Sam was doing it. The senior banker thanked her and approved the transaction.

Two years later, Sam had overspent his money and defaulted on an interest payment to FNB. The bank contacted Ellen and asked that Sardine, as guarantor, take responsibility for repaying the loan. Ellen was surprised to learn that the FNB loan was guaranteed by

Sardine, and at the next board meeting she informed the other directors about FNB's claim. Sam admitted that he signed the guarantee on the firm's behalf without receiving permission from the board, but said that he checked the bylaws and believed that he had the authority to do this as CEO. Patricia told Sam he did not have such authority, and that Sardine will not pay on the defaulted loan.

After the meeting, at her own initiative, Shelly called various banks to see if they would offer Sardine better terms than FNB for their financial business. Second National Bank ("SNB") offered terms that added up to about $1M a year in savings compared to FNB (from lower fees and higher interest paid on Sardine's deposits). Shelly then called FNB's senior banker and said that Sardine was moving all of its business from FNB to SNB (as CFO, Shelly was authorized to decide what bank to use). FNB's senior banker said that FNB was considering making a criminal complaint against Sam for fraud in obtaining the loan from them, and that if Shelly took Sardine's business to another bank, he would make this complaint, but as long as Sardine kept the same amount of business with FNB as before, FNB would not make a criminal complaint about Sam. Shelly decided to continue working with FNB.

FNB sued Sardine to recover the payments on Sam's loan. About a year after Sam's default, while the litigation was progressing, Patricia asked Shelly why Sardine was still doing business with FNB. Shelly told Patricia about FNB's threat to make a criminal complaint against Sam. Patricia informed Sardine's counsel, and Sardine counter-sued FNB for their interaction with Shelly.

Discuss FNB's suit and Sardine's counter-suit.

Model answer for the Fall 2016 BA exam

FNB's suit: Sardine would be liable as a guarantor if Sam had actual or apparent authority to bind Sardine, or if Sardine was estopped from denying Sam's authority.[1]

1. **Actual authority**: None initially, and none by ratification.

a. Liability on the basis of actual authority requires an agency relationship. Here, Sam is Sardine's agent under R3A §1.01 because he acts on Sardine's behalf as the CEO, and he is subject to Sardine's control because he must follow the board's instructions.

b. Sam did not originally have actual authority under R3A §2.01 to make Sardine guarantee his personal loan.[2] Sardine's manifestations (in the bylaws) were that as CEO he could manage "day-to-day business", and it is not reasonable to believe that guaranteeing a personal loan is the day-to-day business of a canned fish producer.[3] Furthermore, even if the CEO has all the authority of the (subordinate) CFO, the CFO's authority to guarantee obligations was subject to the board's approval. Furthermore, if the CEO has authority to guarantee a loan, why would the bylaws require the CFO to get board (rather than CEO) approval? Sam may have believed he had authority, but this belief wasn't reasonable.

c. The board didn't authorize Sam when they "gave their blessing" to the transaction, because they were not informed about a material fact – that the transaction contained a guarantee by Sardine of Sam's obligations. The undisclosed guarantee was the only thing they could have approved, since the rest of the transaction wasn't done on Sardine's behalf.

d. Sardine didn't approve Sam's act when Ellen told FNB that "she knew about the transaction, and that they were quite happy Sam was doing it" ("Ellen's assurance"). First, as an individual director not authorized to act on the board's behalf, Ellen doesn't have actual or apparent authority to ratify on Sardine's behalf. Second, the approval was ambiguous – Ellen thought she was acknowledging that Sardine knew about Sam's loan; she didn't think she was approving anything. Third, Ellen was

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[1] The correct framework to use for FNB's suit was principal's liability for an agent's <u>contract</u> – not tort. It's not clear that Sam committed a tort against FNB – he may have (wrongly) believed that he was authorized, and didn't intend to misrepresent. Sam did breach his implied warranty of authority, but this is not a tort for which Sardine can be vicariously liable – otherwise, nearly all situations in which an actor exceeds actual authority would be tort liability, making the contract liability framework superfluous. Veil piercing also isn't a relevant framework here. FNB wants to hold Sardine liable for an obligation taken by Sam. But this is not reverse piercing – Sam purported to have Sardine guarantee the obligation, whereas in veil piercing the original obligation (of the debtor) is not made on the defendant's behalf. Also, veil piercing is appropriate when siphoning or comingling of assets resulted in shifting assets from debtor to defendant and contributed to debtor's default on the obligation. But there is nothing in the fact pattern that suggests Sam's default on FNB's loan was due to his moving assets into Sardine.

[2] Note that the authority we are exploring is to guarantee the loan, not to take the loan. Sam is taking the loan (borrowing the money) in his personal capacity, not on Sardine's behalf.

[3] In *Willey v. Mayer* an authorization to grant a security interest on the firm's behalf was seen as authorizing the actor to make the firm guarantee the actor's personal loan. This is an appropriate analogy, but in *Willey* the manifestation (in a power of attorney) specifically authorized the agent to create security interests, without making any qualifications. The court refused to read an implied exception for improper purpose. In the exam, the authorization is to conduct the firm's "day to day business", in which case the fact that the loan is personal and not for the firm is relevant.

uninformed about a material fact – that the transaction contained a guarantee by Sardine of Sam's obligations.

2. **Apparent authority**: Unlikely but possible.

a. Sam would have apparent authority under R3A §2.03, if FNB could reasonably believe Sam was authorized, based on Sardine's manifestations to FNB. Sam's claim to have authority is not a manifestation from Sardine.
b. Sardine did manifest that Sam has all the authority of a CEO, but this would likely include day-to-day business, and not a guarantee of a personal loan. Also, the banker's hesitation despite knowing Sam was CEO suggests FNB didn't believe CEO status gave Sam the authority.
c. Ellen's assurance was also a manifestation to FNB. It's a misunderstanding, but what matters is FNB's reasonable interpretation of it. Possible but unlikely this is enough to create apparent authority. First, as an individual director, Ellen probably lacks authority to make manifestations on Sardine's behalf. Second, neither the banker's question nor Ellen's manifestation addressed Sardine's guarantee – both referred to Sam's loan.

3. **Estoppel**: Sardine is possibly liable due to estoppel.

a. FNB suffered a **detrimental change in position** by giving Sam the loan (on which he defaulted) at a lower interest rate in reliance on Sardine's guarantee. If FNB knew Sam was unauthorized, they would still lend to him (at higher rate), and would suffer Sam's default. Therefore, recovery is limited to the loss in interest payments until Sam's default.
b. FNB's change in position was probably **justifiably induced** by Ellen's assurance. Ellen was not informed about Sardine's guarantee of Sam's loan, but FNB could be justified from Ellen's response to believe that she was informed. One may question if it is justifiable to believe Sam was authorized based on a statement from an individual director, and Ellen's assurance was vague and did not directly discuss Sam's authority, but it may be enough to justify FNB's inducement into the loan.
c. Sardine had no notice of T's inducement (they did not know that FNB believed Sam was representing Sardine in the loan agreement), but Sardine likely was careless in causing FNB's belief. Ellen should have wondered why FNB asks for Sardine's opinion if Sardine was not party to the transaction. She represented to FNB a positive opinion about the transaction, which could (and did) lead FNB to believe Sam had authority to act for Sardine. The weakness in FNB's argument is whether Ellen can make manifestations for Sardine as an individual director.

Sardine's suit: FNB is liable to Sardine for the $1M they could have saved had they moved their business to SNB, because Sardine can establish that FNB aided and abetted Shelly's FD breach.[4]

[4] Some students attempted to establish FNB's liability based on a breach of fiduciary duty to Sardine (as its bank). This is wrong. While some banking services may create an agency relationship (e.g., bank purchasing securities on client's behalf), ordinary banking services are provided in an arm's-length market relationship, not an agency relationship. If FNB acted as Sardine's agent for some services, it was not mentined in the fact pattern and does not related to the banker's conversation with Shelly. Also, some students attempted to establish FNB's liability based on a principal's liability for an agent's tort. This, too,

1. Duty: In the alleged FD breach, Shelly acted as CFO (not as director). As CFO she was Sardine's agent, managing Sardine's finances and subject to the CEO's and board's control. Therefore she owed Sardine a FD.

2. Breach of duty: Shelly breached her FD by self-dealing
   a. Duty: Shelly owed Sardine a FD as its agent (see 1)
   b. SoR: Shelly is an agent, so agency SoR applies
   c. Application: Shelly was self-dealing in deciding not to move Sardine's business from FNB to SNB. Sardine's interest was minimizing costs, but Shelly's personal interest was protecting her father from a criminal complaint. The conflict is connected with the agency relationship since it stems from Shelly's decision on Sardine's behalf (which bank to use). Under agency SoR, any self-dealing breaches FD.

3. Knowing participation: FNB made a threat to Shelly's self-interest (her interest in protecting her father) rather than to Sardine's interest, and used the threat to cause Shelly to decide, on Sardine's behalf, not to take business away from FNB. Therefore, FNB's threat was aimed to cause Shelly to self-deal and breach her FD.

4. Damages proximately caused by the breach: Due to the breach Sardine continued to work with FNB rather than SNB, and so Sardine failed to save $1M in lower fees and higher investment interest.

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is wrong. It is not clear at all that the banker committed a tort against Sardine: he did not threaten to lie or to act wrongfully (e.g., using violence); only to truthfully report Sam's behavior. This could create aiding & abetting liability if the bank knowingly causes Shelly to breach her FD to Sardine, but it does not amount to a tort against Sardine.