University of Illinois College of Law
Examination Cover Sheet

Business Associations
Professor Amitai Aviram
Fall Semester 2017
Number of Pages: 5 (including this page)
Time Allotted: Until 10am on the day following the day you received the exam
Assistant Name: **Clyde Gabriel**; Assistant e-mail: **cgabriel@illinois.edu**

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, UPA, 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.

Midas Inc. ("Midas"), a Delaware corporation, provides retail online foreign exchange trading services. In other words, when an individual wants to buy or sell foreign currency, they can do so through Midas' website.

Midas' board consists of five directors: Alison, who is Midas' CTO (Chief Technology Officer); Bradley, who is Midas' CEO (and Alison's direct boss); Cassandra, who is the CEO and owner of 70% of the shares of General Investments, Inc. ("GII"), a publicly-traded conglomerate; David, a retired foreign currency trader who owns 5% of GII's shares; and Ellen, the CEO of a technology start-up and Bradley's wife. None of the directors have a legal education or experience as lawyers.

Basics of leveraged trading: Many of Midas' clients are foreign currency speculators who make leveraged trades. In other words, they borrow from Midas most of the money to cover a purchase, paying Midas only a "margin": a down payment of a certain percentage of the cost. They pay the rest when they sell the foreign currency.

For example, if a client wants to buy 100 dollars' worth of Euros, and Midas set a margin of 5%, the client would pay Midas $5 and borrow from Midas the other $95. Midas would then buy the Euros in its own name and hold on to them (noting in its records that they belong to the client). When the client instructs Midas to sell the Euros, Midas collects from the proceeds the $95 owed to it, plus interest on the loan of $95 and plus trading fees.

Such a business model presents the risk that if the trade turns badly for the client, the client may default on the loan. To illustrate, if the Euro dropped by more than 5%, the client's purchase would now be worth less than $95, so Midas would not be able to recoup its loan (let alone interest and fees) from selling the client's Euros.

To protect itself, Midas had the right to make a "margin call": demand a larger margin from the client (essentially, require the client to pay back some of the loan). When a margin call is made, the client must either pay the increased margin, or Midas may "close the client's position" (sell the client's investment to cover what is owed to Midas).

To illustrate, suppose the Euro dropped by 3%, and Midas demanded to increase the margin by $4 (meaning that the client would pay another $4, and the loan would drop to $91). If the client fails to pay the extra $4, Midas will sell his Euros (which after the 3% drop are worth $97), deduct from it the $95 loan plus interest and trading fees, and give the client the remaining money, if any.

In most cases, the right to make margin calls and to close a position if the client doesn't comply protects Midas from a client's trading losses. However, if the market is volatile, an investment could drop sharply in value before Midas could sell it, so it wouldn't cover the amount owed to Midas. For example, if the Euro fell sharply by 15% and the client refused Midas' margin call, selling the client's Euros would yield only $85. This wouldn't be enough to cover the $95 the client owes Midas. In such a case, however, Midas could sue the client to recover the rest of the money it's owed.

Midas' new business plan: Midas faced stiff competition from other foreign currency trading services, and looked for a way to increase its market share. Bradley suggested

that Midas would offer what he called a "non-recourse margin loan" ("NRML") – that is, when Midas closed a client's position (either at the client's request or because the client refused its margin call), Midas would only recover the loan from the proceeds of the sale. Midas would promise not to sue the client, even if the proceeds from closing the position were not enough (as in the last example above).

The board recognized that NRMLs made Midas vulnerable to losses from a quick and significant drop in the value of a client's investment. Bradley argued that Midas was still protected from losses by its ability to make margin calls and immediately close positions of clients who refused. To allow Midas to act swiftly, Bradley suggested that Midas would purchase a customized computer system that monitored all trades, automatically made margin calls, and closed positions quickly if clients refused.

After thorough deliberation and review, the board unanimously agreed to purchase the computer system, begin offering NRMLs, and advertise Midas aggressively as the firm that does not come after you (the client) when you take a loss.

The Midas touch: Midas installed the computer system and publicized its NRMLs: "One of the greatest concerns traders have about leverage is that a sizable loss could result in owing money to the broker. At Midas, your maximum risk of loss is limited by the amount in your account. You will never owe a deficit as a result of trading." In its advertising, Midas explained that it had the confidence to offer NRMLs because of its unique computer system, which quickly responds to market changes by making margin calls and closing positions.

Midas' timing was perfect. New clients flocked to use Midas for their trading, and the company quickly became one of the largest players in the market. The computer system appeared to function very well, getting through several episodes of volatile markets without Midas taking a loss. With far more clients and (so far) no losses from NRMLs, Midas' profits increased dramatically.

New regulation: Then a cloud appeared on the horizon. The Commodity Futures Trading Commission ("CFTC"), which is the federal regulator of foreign currency trading, issued a new regulation that prohibited foreign currency traders (such as Midas) from representing that they would limit or reimburse their clients' trading losses ("the Regulation"). Lynn, Midas' General Counsel, alerted the board to the Regulation, and wrote a detailed legal analysis that concluded that NRMLs likely violate the Regulation.

When the board met to discuss the issue, they strongly disagreed with Lynn's conclusion. Bradley argued that Midas was not limiting trading losses, but offering clients a loan; and non-recourse loans were common in many other financial sectors. Lynn said she was simply stating her interpretation of the Regulation. Bradley replied: "Well, your interpretation is wrong. NRMLs made us the industry leader, and we'd be crazy to give them up just because you're coming up with legal problems." The other directors agreed. They decided unanimously that they rejected Lynn's legal opinion, that the board believes that NRMLs were loans not subject to the Regulation, and that Midas would continue to offer them.

For a few months, business continued to boom at Midas. Then a whistleblower alerted the CFTC, which opened an investigation into the NRMLs. At the conclusion of the investigation the CFTC sued Midas for violating the Regulation by offering NRMLs. Midas settled the suit, paying a fine of $10 million and agreeing not to offer NRMLs.

<u>He said, she said</u>: Lynn was fired. A Wall Street Journal reporter contacted Bradley and asked why she was fired. Bradly responded "no comment". The reporter then told him that Lynn agreed to be interviewed, and that if Bradley would like his side of the story described in the article the reporter was writing, he would need to comment. Bradley told the reporter he would call him the next day to tell his side of the story.

That afternoon Midas' board met, and Bradley told the other directors about his conversation with the reporter. Bradley said that the best defense for Midas would be offense – to blame Lynn for the NRMLs' illegality, which would seem credible since they fired her immediately after settling the CFTC action. The other directors were silent for a few moments, then Ellen said "Bradley, I'm sure you'll handle this matter with integrity." The other directors stayed silent for a few seconds, and then David changed the subject, beginning to talk about the next issue on the agenda.

The next day, Bradley told the reporter that Lynn was fired because she assured the board that NRMLs were legal, and the board relied on her advice. He added that Lynn was bad at taking responsibility, and tends to blame others for her mistakes.

The Wall Street Journal article appeared later that week. It quoted Bradley's statements, as well as Lynn's claim that she warned the board about NRMLs' illegality. While the article didn't pick sides, the controversy around Lynn's integrity caused potential employers to avoid hiring her. Lynn sued Midas for Bradley's statements to the reporter. You should assume that Bradley is liable to Lynn for his statements.

<u>Raising money</u>: Meanwhile, without the NRMLs, many clients deserted Midas. The sudden loss of business and the cost of the fine caused Midas to have less capital than CFTC rules required. The CFTC threatened to prohibit Midas from trading foreign currency if it did not quickly raise enough capital to return to compliance with CFTC rules.

Bradley sought to raise capital by issuing new Midas shares that would amount to a 60% interest in Midas. He hired Silverman Partners, LLP ("Silverman"), an investment bank, to search for investors. When Silverman reported that they concluded their search, the board then met to decide who to sell the shares to. Silverman reported to the board that they solicited two offers from interested parties. Opportunity Investment Fund, LLC ("OIF") offered the highest price, but it was a small firm that didn't enough money to pay for all of the shares. The other offer, from Lucky Corp. ("Lucky"), was slightly lower but Lucky clearly had the funds to pay for the shares.

Silverman then said that to solve OIF's funding issue and enable Midas to accept the higher offer, it (Silverman) would join OIF's bid, providing one-third of the money and getting one-third of the shares. According to Silverman, OIF and Silverman agreed to jointly control Midas, should Midas accept their offer. Silverman said OIF would have enough funds (just barely) to pay for their two-thirds of the shares, and with the financing

problem resolved in this way, Silverman recommended that the board accept OIF's offer since it was the highest price.

The board then spent a long time reviewing the two offers and Silverman's report, and discussing the merits of each offer. Cassandra supported and Ellen said they supported OIF's offer because it was the highest, while Bradley expressed concern about OIF's ability to finance the purchase even with Silverman's participation.

During a break in the board meeting, Cassandra pulled Bradley aside to speak with him privately. She told him that he was right that even paying for just two-thirds of the share purchase was stretching OIF's financial ability, but for that reason OIF has invited GII (the firm Cassandra controlled) to co-invest, so that OIF, GII and Silverman each paid one-third of the cost and would own one-third of the newly issued Midas shares – and the three would jointly control Midas. Cassandra said that GII's board had not decided about this yet, but was likely to agree. However, until GII's board decided, this information had to remain secret to prevent anyone from insider trading on GII's shares with this information – even large GII shareholders like David didn't know about OIF's offer. Therefore, Cassandra told Bradley, he should not disclose this information to anyone. She was just telling him about it to assuage his concerns that OIF could not raise the money to buy the shares. Bradley promised to keep this information confidential and not tell anyone.

When the board reconvened from the break, the directors agreed unanimously to accept OIF's offer (and reject Lucky's offer).

Endgame: Before the deal could close, Midas' directors were sued derivatively (on Midas' behalf) by Sam, a Midas shareholder who was also the controller of Lucky. Sam alleged that the directors breached their fiduciary duty to Midas in approving OIF's offer, and asked the court to enjoin the board's decision approving OIF's offer and force the board to reconsider. Assume Sam has standing to sue on Midas' behalf. **Discuss Lynn's suit and Sam's suit**.

Model answer for the Fall 2017 BA exam[1]

1. Lynn's suit:

a. Actual authority: Midas would be liable for Bradley's defamation if he's Midas' agent and the board's behavior at the meeting authorized him to defame Lynn (R3A §7.04).

Bradley is Midas' agent. He acts on Midas' behalf as its CEO, and is subject to Midas' control through his duty to follow the board's instructions (R3A §1.01).

Midas' manifestation that Bradley is CEO authorizes him to manage the ordinary course of Midas' business, which reasonably includes representing Midas to the press. However, discussing the issue with the board suggests Bradley believed he lacked authority. Board is an appropriate authorizer due to their plenary authority (DGCL §141(a)). They were fully informed. Ellen told Bradley to act with "integrity", which doesn't facilitate reasonable belief that he should lie. But Bradley explicitly said he should lie, and Ellen's evasive response plus the board's acquiescence accommodated Bradley's suggestion, when they could easily tell him not to lie. Finally, board's failure to correct the record after the article was published possibly ratified Bradley's behavior. Plausible case for liability based on actual authority.

b. Apparent authority: Midas would be liable if an act with apparent authority constituted the tort (R3A §7.08). Midas manifested to the reporter that Bradley was its CEO.[2] This made the reporter reasonably believe that Bradley can speak for Midas about the behavior of a Midas employee. Midas is liable to Lynn based on apparent authority.

c. Respondeat superior: Bradley is Midas' employee because he's Midas' agent (see 1a), and Midas controls the manner and means of his conduct – not just what tasks had to be done, but how to do them. For example, he consulted the board on what to say to the reporter, and must comply with their instructions.

Bradley's defamation was within SoE. Under the control test, speaking to reporters was a course of conduct subject to Midas' control (board could instruct him what to say). Under the purpose test, Bradley's motivation was protecting Midas' reputation by placing blame on Lynn. He was possibly also protecting his personal reputation, but a mixed

[1] The exam fact pattern is partially based on the facts of *Kandell on behalf of FXCM, Inc. v. Niv*, Not Reported in A.3d, 2017 WL 4334149 (Del.Ch. 2017).

[2] Some answers erroneously analyzed the manifestations perceived by Lynn. This is wrong in the case of defamation, since lying about Lynn's behavior and character to Lynn would not harm her and would not be defamatory. It is the perception of the journalist or the WSJ readers that matters in the case of defamation, so it was Midas' manifestation to the journalist (or the WSJ readers) that Bradley was CEO that formed the apparent authority that facilitated Bradley's defamation. Also, some answers erroneously said that the manifestation creating the apparent authority was Bradley's statements. That is wrong because the manifestations creating apparent authority must come from B, not from A. Bradley's statements created Bradley's liability for the tort of defamation; Midas' manifestation that Bradley was CEO is what created the apparent authority that Bradley's statements were Midas' statements, and therefore made Midas also liable for that tort.

motive is still within SoE (*Reynolds*, *Meltzer*). Midas has respondeat superior liability (R3A §7.07).

d. Negligence: P owes a DoC to T regarding foreseeable risks from an employee's behavior, when the employment facilitated A's causing harm to T (R3A §7.05(1), R3T §41(b)(3)). Bradley employment as CEO facilitated Lynn's defamation, so Midas owed Lynn a DoC. The harm was foreseeable because Bradley told the board he plans to defame Lynn. Midas breached their DoC by failing to assert control to prevent Bradley from defaming Lynn; a reasonable board would explicitly prohibit Bradley from lying.

<u>2. Sam's suit</u>:

a. Duty: Defendants are Midas directors, so they owe FD to Midas.

b. SoR: Majority of directors (4/5) are likely conflicted, so entire fairness applies.[3]

   1. Cassandra is directly conflicted – she anticipates that GII, which she controls, will be part of the group buying the shares (so would want a low price and would want to select OIF's offer over Lucky's offer). Midas, in contrast, wants the best offer (it is true that OIF's offer is higher priced, but it may have financing problems, and Midas may want to play OIF against Lucky rather than just accept OIF's offer). The conflict is connected to Cassandra's fiduciary position because she is voting on it as Midas' director.

   2. Alison, David and Ellen are constructively conflicted if Cassandra violated her duty of disclosure – that is, if the information is related to the directors' decision-making or oversight functions (it is, connected to the OIF deal vote), if the information is material (it is, a reasonable director would believe Cassandra's interest is relevant to the firm's reputation for fair dealing, and to evaluating Cassandra's support of the deal), and if there is no superior duty to maintain confidentiality. This last point is uncertain – Cassandra claims she avoids disclosure to prevent insider trading. But this can be done by requiring all directors to promise confidentiality (as Bradley did). If this negates the "superior duty" argument, entire fairness applies.

   3. Otherwise, enhanced scrutiny applies because in accepting the OIF deal the board has embarked on a transaction that will result in a change of control (*Revlon*) – buyers will collectively own 60% of Midas, and agreed to jointly control Midas.

c. Application – Entire fairness (*Weinberger*)[4]:

[3] Bradley is not conflicted. Even if he had a duty to disclose to the other directors what Cassandra told him, it is not the person violating the duty to disclose that is constructively conflicted, but the persons who did not receive the disclosure. And those persons (Alison, David and Ellen) cannot become conflicted by Bradley's failure to disclose because Bradley himself is not conflicted. They can become constructively conflicted, though, if Cassandra breaches a duty to disclose (because Cassandra's conflict is constructively attributed to them).

[4] Some answers erroneously applied the *Guth* test, which examines usurping corporate opportunities. This is wrong because Midas was not interested in an opportunity ("usurped" by Cassandra) to buy its own shares. The flaw in Cassandra's behavior was not that she took the opportunity to buy Midas' shares away from Midas, but that she was part of the board deciding whether to sell Midas shares to an entity she

1. Fair process: Process very flawed. The financial advisor that solicited the offers and advised on them is an adverse party (one of the buyers), so Silverman has no incentive to identify better offers or to advise playing bidders against each other. Directors knew they had no independent (non-conflicted) information and expertise to confirm that OIF's offer was the best they could get. Cassandra strongly influenced the process by advocating acceptance of OIF's offer, without disclosing that she was an adverse party.

2. Fair price: Silverman solicited offers, and OIF's offer was the highest, suggesting a fair price. But given their conflict, they lacked incentive to search hard or advise playing bidders against each other.

3. When process is very flawed, court can find FD breach even if price is fair (*Nine Systems*). Here, process is very flawed and price fairness is questionable, so FD is breached.

d. Application – Enhanced scrutiny[5]:

1. Legitimate purpose: Midas must sell shares to comply with CFTC rules. OIF deal isn't illegal or corporate waste (SHs gain from complying with CFTC rules, and OIF's offer is higher than Lucky's).
2. Reasonable investigation: Board failed to conduct a reasonable investigation, for the reasons stated in 2c1. FD is breached.
3. Good faith: If Enhanced Scrutiny applies then only 1/5 directors were conflicted (see 2b3), so board was independent.
4. Reasonableness: Board's action isn't preclusive (OIF deal will fail if SHs vote against it). It isn't coercive (SHs are free to vote against it). But it is "otherwise unreasonable" to sell control of Midas in a process that directors know is deeply flawed (for reasons stated in 2c1).

---

controls, and thus her personal interest in accepting OIF's offer and paying less for the shares conflicted with Midas' interest in selecting the best offer and receiving more for the shares. Also, some answers applied both the general test (is the challenged act in the SHs' interest?) and the *Weinberger* detailed test for transactions (fair process/fair price). This is not wrong, but "wastes" words for the exam word limit, because the detailed test is perfectly applicable to analyze a decision whether (and to whom) Midas would issue shares. Applying the general test was superfluous. The general test should be used when the detailed test is not applicable (for example, analyzing a challenge that the board failed to do something, in which case there is no process and no price/terms to analyze.

[5] Normally, when both entire fairness and enhanced scrutiny apply, only entire fairness needs to be analyzed because it is the more rigorous SoR. The reason enhanced scrutiny was also analyzed in this exam is that it is not certain that entire fairness applies (it does not if Cassandra had a superior duty that prohibits disclosure, see 2b2). If entire fairness does not apply, enhanced scrutiny would, which is why it is analyzed in this exam answer.