

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

Business Associations

Professor Amitai Aviram

Fall Semester 2018

Number of Pages: 5 (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, 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 are not necessarily true in real life.

Golden Gate Inc. (“GGI”) is a Delaware corporation, engaged in asset management. GGI’s charter does not exculpate directors for negligence that breaches their fiduciary duty to the company.

Derek joined GGI as an analyst right after graduating from college. Almost immediately, he distinguished himself through his gregariousness (always making friends and expanding his professional network), his tirelessness (when he wasn’t schmoozing, he was in the office analyzing reports on various potential investments), and his attention to detail (he could spot flaws in accounting figures and valuation models with ease).

Derek rose up the ranks of GGI in record time. He was appointed fund manager when he was 25 – the youngest ever in GGI. At 29, he was promoted to “partner” rank (a senior rank from which GGI’s senior officers are selected, but one that did not imply management rights, since GGI was a corporation managed by its directors, not a partnership). Again, Derek broke the GGI record.

Two years later, GGI promoted Fiona, the head of the hedge funds division, to become GGI’s Chief Financial Officer and a director on GGI’s board. Derek competed with another young partner, Ben, for Fiona’s old position. Derek prevailed and GGI appointed him to head the hedge funds.

When GGI announced Derek’s promotion, John (one of the fund managers) went to Derek’s office to congratulate him. “What next, Derek?” said John. “What do you give the man that has it all?”

“What I need now,” replied Derek, “is a hot secretary. That’ll show my status at the firm.”

Ben happened to pass by Derek’s office just then, and heard the statement, which Ben found to be crass and sexist. Ben reported the incident to Angela, GGI’s Chief Human Resources Officer (who is also one of GGI’s directors).

* * *

At the next board meeting, Angela told the board about Ben’s report. GGI’s board consisted of five directors: Angela, Fiona, Gary (GGI’s CEO), Carl (GGI’s General Counsel) and David (a retired, former CEO of GGI).

Fiona shrugged it off. “This is immature behavior, but what do you expect? Derek’s so talented that he got to a senior position at an unusually young age. He’ll grow out of this behavior.”

Carl strongly disagreed. “This might be just the tip of the iceberg. Precisely because Derek rose so far so fast, no one would dare complain about him. We have to investigate deeper to see if he’s done worse.”

“Where did this complaint come from?” asked Gary.

“Ben,” Angela replied.

“Couldn’t this just be sour grapes about losing the division head position to Derek?” asked Gary, “This incident may not have happened at all.” David nodded. All directors knew that Ben was Carl’s protégé and preferred candidate for the division head position, while Derek was Fiona’s protégé and preferred candidate.

Carl insisted that GGI could face legal liability if it did not have a system to investigate sexual harassment, beginning with a more thorough investigation of Derek.

“We have a system already, Carl,” said Fiona. “It’s called complaining to the Chief Human Resources Officer. And it clearly works, since we’re discussing such a complaint right now.”

Angela, Gary and David felt the same way, but they were uncomfortable ignoring a warning from their own General Counsel about potential legal liability. As a compromise, the directors agreed that the existing reporting system needed no change, but in response to Ben’s report, the board created a special committee, consisting of Carl and Fiona, to investigate Ben’s complaint against Derek (“the Committee”).

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The Committee interviewed all the employees that they determined may have relevant information. John corroborated Ben’s report about what Derek said to him. A number of additional incidents of unprofessional behavior came up, though no employee alleged suffering or witnessing explicit harassment.

One employee, Rose, said that one evening as she was about to leave work, she bumped into Derek in the hall just outside his office. He appeared drunk, was not wearing a shirt, and told her: “I had a really bad day and need a hug” and extended his arms towards her. Rose gave him a brief hug and immediately pulled away and left the building.

Fiona asked Rose whether she felt coerced. Rose said she did not. To Carl, Rose seemed to hesitate, look intently at Fiona as if assessing the impact the answer would have on her, and then sigh and answer. Carl also felt that Fiona’s tone was prosecutorial, as if Rose was on trial. Fiona, in contrast, thought that her tone was professional and that Rose answered the question without hesitation.

Other employees reported that Derek told them offensive jokes. Fiona asked these employees whether they ever told Derek that they did not appreciate this kind of humor. Again, Carl felt that these employees were holding off on more incriminating information because they perceived that Fiona supported Derek.

Frustrated, Carl asked Fiona to resign from the Committee or allow him to interview the witnesses again, alone. Fiona refused, stating that the committee was composed of both of them, and that she was not influencing the witnesses in any way.

The Committee reported to their findings to the board. Fiona and Carl agreed that the reported behavior was unprofessional but did not amount to harassment. However, Carl insisted that he was sure Derek did harass some of the witnesses they interviewed, but the witnesses were afraid of reporting this to Fiona, whom Carl claimed the employees saw as “Derek’s patron”. He asked that the board hire a law firm or private investigator to investigate Derek’s behavior, and meanwhile place Derek on leave (which, all directors understood, would likely mean appointing Ben to head the hedge funds in the interim).

Fiona accused Carl of stirring up accusations in order to promote Ben over Derek. Carl swore that his only motivation was to protect GGI’s employees from Derek’s abuse.

“Even if your motives are pure, Carl,” said Gary, “we’ve already done an investigation. We can’t re-investigate just on the basis that the witnesses did not tell you what you expected to hear.”

In a 4-1 vote (with Carl voting against), the board determined that Derek acted unprofessionally but did not commit sexual harassment, and decided to deduct 1 month’s base salary from his annual bonus as punishment for the unprofessional behavior. Because the typical bonus Derek could expect in his position was several times his base salary, this punishment amounted to about 1% of his expected total compensation.

* * *

Carl was furious about the board’s decision. He felt certain from some of the witnesses’ body language that Derek harassed or even assaulted them, but Fiona’s presence at the interview and the perception that Derek was a rising star at the firm intimidated the witnesses from telling the committee about these incidents.

Finally, Carl decided that he was morally bound to protect GGI’s employees from future abuse, and to do so he had to force Derek out of the firm. He contacted Janice, a reporter at a financial newspaper, and told her that Derek had sexually harassed – and possibly sexually assaulted – employees at GGI, and that the board intentionally “buried its head in the sand” so as not to harm the career of a highly-profitable employee. Carl was aware that GGI’s Communications Policy required him to get Gary’s permission before he spoke with journalists on company matters, but he knew Gary would not approve of this message, so he did not ask for permission.

Janice reported Carl’s allegations, and it immediately became front-page news. Within the firm, no new allegations of misbehavior surfaced, but employees reported losing business because clients did not want to be associated with GGI. The board decided not to comment on the allegations in the article, out of fear that responding would focus more attention to the matter. But the commotion would not die down. Within a few days, Gary was summoned to appear before a Congressional committee that decided to hold hearings on the matter.

Gary called Fiona and told her: “Whether Derek was harassing or just juvenile, he’s too much of a liability now. You need to cut him loose.”

Fiona then met with Derek and (without mentioning her conversation with Gary) told him he needed to resign or else he’d be fired. Derek offered to resign and to waive any severance payments he was entitled to, if GGI promised to affirmatively say, in all of their public statements on the matter, that a board committee investigated his behavior and found that he did not sexually harass anyone at GGI. Fiona accepted, and Derek resigned. Fiona reported her agreement with Derek to the Board later that day, and the board accepted Derek’s resignation.

Janice now contacted Fiona, who told Janice that a board committee investigated Derek’s behavior and that Derek did not sexually harass anyone at GGI.

With apparently conflicting statements from Carl and Fiona, Janice contacted Gary and asked whether the board investigated Derek and found he did not commit sexual harassment.

“The board did create a committee that thoroughly investigated the allegations against Derek,” replied Gary. “I cannot say that Derek did not commit sexual harassment. I can say that he’s no longer working for GGI.”

Derek could not get a new job. He sued GGI for Carl’s & Gary’s statements to Janice. You should assume that Carl’s statement to Janice made him (Carl) personally liable to Derek for the tort of defamation, and that Gary’s statement to Janice did not make him (Gary) personally liable to Derek for the tort of defamation.

Meanwhile, GGI’s share prices plummeted. Shelly, a GGI shareholder, sued GGI’s board on behalf of GGI (you should assume she had standing), alleging the directors breached their fiduciary duty to GGI by failing to address the risk of sexual abuse in the company and by inadequately investigating Derek.

Discuss both Derek’s and Shelly’s suits.

Model answer for the Fall 2018 BA exam¹

1. Derek's suit – Carl's defamation:

GGI is liable in torts for Carl's defamation through Respondeat Superior, though not actual or apparent authority and probably not negligence.

- a. Actual authority: Carl is GGI's agent because he acts on GGI's behalf as its General Counsel and in that role is subject to the control of GGI's CEO and board (R3A §1.01). Carl's statement to Janice conflicted with the board's conclusion that Derek didn't harass, and violated GGI's Communications Policy, so he wasn't granted actual authority. Did the board ratify the report by failing to deny it? The board was fully informed, but their lack of action is at least ambiguous – intended to reduce public attention, not to acquiesce to Carl's allegations. No actual authority.
- b. Apparent authority: Janice and newspaper readers didn't reasonably believe that Carl spoke on behalf of GGI when he accused Derek of sexual misconduct and the board of turning a blind eye.² He sounded like a whistleblower, not a company spokesperson.³ Therefore, Carl didn't have apparent authority to defame Derek.
- c. Respondeat Superior: Carl is an employee even under the narrower *Vandemark* test because regarding the instrumentality of the harm (communicating with reporters), GGI's communication policy controls the manner in which he can communicate with media.⁴ Communicating with Janice was within SoE. Under the control test, it wasn't work assigned to him but it was subject to GGI's control (e.g., controlled by the Communications Policy). Under the purpose test, Carl's intention was to protect GGI employees from future harassment (i.e., serving GGI).⁵ So GGI is liable for Carl's defamation under Respondeat Superior.

¹ Part of the fact pattern is loosely based on: Rachael Levy, *D.E. Shaw Partner Fights Back After Firing*, Wall St. J. (Sept. 10, 2018), p. B1.

² Liability based on apparent authority requires that acts taken with apparent authority constitute the tort, but it does not require that the object of the apparent authority (the T with whom A dealt with apparent authority) would be the tort victim. Indeed, in cases of defamation using apparent authority, T is almost certainly someone other than the victim of the defamation, because A cannot defame T by making false statements to T. Therefore, on this issue in the exam, what mattered is Janice's (and the newspaper readers') reasonable belief regarding Carl's authority, not Derek's reasonable belief.

³ Carl's position as General Counsel and senior GGI executive did make his allegations credible to Janice and the newspaper readers, but the test is not whether B's manifestations make A's statement credible, but whether those manifestations make A's statement appear to be authorized for A to express on behalf of B.

⁴ As General Counsel (with greater expertise in law than the CEO and board have), GGI likely does not control the manner & means (the "how") of Carl's conduct of legal work. But it does control the manner & means of his conduct of other tasks (such as communicating with the media), which would make him an employee under the broad test, and would also make him an employee under the narrower *Vandemark* test when, as in this case, the tort involves not his legal work but his communication with the media.

⁵ Carl may have had a personal motivation in defaming Derek to advance his protégé, Ben. However, as long as he also wanted to protect GGI's employees, he had mixed motives which would usually suffice for the act to be within SoE.

- d. Negligence: Duty:⁶ GGI owes a DoC regarding risks posed by GGI's employees, when the employment facilitates the employee's causing of harm (R3A §7.05(1), R3T §41(b)(3)).⁷ Here, Carl's position as General Counsel made his allegations against Derek more credible to Janice and the newspaper readers than if they came from a non-employee. Breach: Since GGI had the Communications Policy and Carl didn't give warning that he was going to defame Derek, it's not clear that the harm to Derek was foreseeable or that GGI could reasonably do more to protect Derek from such harm. Perhaps the duty required GGI to make an immediate corrective statement once GGI was aware of Carl's statement. But probably no negligence, despite the existence of a duty.

2. Derek's suit – Gary's breach of Fiona's contract:

If the agreement between Fiona and Derek bound GGI, then GGI breached the agreement when Gary failed to affirmatively say Derek didn't commit sexual harassment. There is no liability based on apparent authority or estoppel, and Fiona likely didn't have actual authority, but the board ratified the agreement.⁸

- a. Actual authority: Fiona is GGI's agent because she acts on GGI's behalf as its CFO and in that role is subject to the control of GGI's CEO and board (R3A §1.01).⁹ Fiona's position lacks authority to commit GGI's public statements (see 2b), but Gary has authority to do so per the Communications Policy. Did he delegate his authority to Fiona in telling her to "cut [Derek] loose"? This could be interpreted narrowly to only authorize firing Derek or getting him to resign. But if

⁶ Some students mistakenly discussed the exculpation clause regarding this issue, but it is irrelevant here. The exculpation clause addresses liability of a firm's directors towards the firm. It doesn't address liability of the firm towards third parties, which is the issue here.

⁷ Rather than analyzing a duty based on B's relationship to the tortfeasor (R3A §7.05(1)), some students analyzed a duty based on B's relationship to the tort victim (the "employer-employee" special relationship between B (GGI) and T (Derek), based on R3A §7.05(2); R3T §40(b)(4)). This isn't wrong, but it's a less satisfactory answer because the case for negligence is even weaker based on that duty. Such a duty involves the care GGI must take to protect its employees from defamation by anyone (including people who have no connection to GGI), since this duty is not dependent on who committed the tort but on who is harmed by it. So, Derek's case based on this duty is no stronger than if someone with no connection to GGI (e.g., a rival banker working at a competing firm) told Janice that Derek committed sexual abuse. The case for negligence on the exam is stronger than this hypo because the defamation came from a GGI employee, but liability for that must be based on R3A §7.05(1) (duty based on B's relationship to tortfeasor), not on R3A §7.05(2) (duty based on B's relationship to tort victim).

⁸ Many students missed entirely or improperly analyzed this issue. The tort analysis framework is inapplicable because the fact pattern states that Gary didn't commit a tort (and there's nothing in the fact pattern saying that it would have been a tort had the same actions been committed by GGI but not by Gary). Likewise, analyzing liability by applying the contract analysis framework to Gary's statement was incorrect because Gary's statement didn't create a contract with Derek; rather, it (allegedly) breached it. To establish GGI's liability to Derek in contracts, one must analyze the actions that purported to create this contract: Derek's agreement with Fiona.

⁹ Some students analyzed Fiona's actions as if she were Gary's agent. This is wrong. When Gary delegated to Fiona to deal with Derek's resignation/firing, she did not act on Gary's behalf, but rather she acted on GGI's behalf using authority delegated to her by Gary, her superior co-agent (not her principal). For that reason, it was also wrong to analyze virtual apparent authority. Derek knew that Fiona was negotiating with him on GGI's behalf. The fact that he didn't know about Gary sending Fiona to do so affects the manifestations creating apparent authority, but it doesn't make the principal undisclosed (because the principal is GGI, not Gary).

- committing GGI's public statements is "incidental" to "cutting Derek loose", then under R3A § 2.02(1) Fiona had Gary's authority. Either way, the board ratified by accepting Derek's resignation. Fiona informed the board about the agreement, and it would have been easy to inform Derek that Fiona had no authority to commit GGI's public position. Instead, they accepted the benefit of Fiona's agreement. GGI was therefore bound by the agreement and then breached it through Gary's statement to Janice (which Gary made with actual authority per the Communications Policy).
- b. Apparent authority/Estoppel: Fiona didn't tell Derek she was sent by Gary, so the only manifestation Derek had was that Fiona was GGI's CFO. The CFO reasonably doesn't have authority to commit GGI's public statements (the Communications Policy gives this authority to the CEO). No apparent authority. Likewise no estoppel. Derek made a detrimental change in position by resigning. But he wasn't justifiably induced to do so, since the CFO doesn't reasonably have authority to commit GGI's public statements.

3. Shelly's suit:

- a. Duty: As directors, the defendants owe GGI a fiduciary duty.
- b. SoR¹⁰: Board didn't deploy powers against SH's rights and didn't embark on a change of control,¹¹ so no enhanced scrutiny. Board wasn't self-dealing, so BJR applies to that claim.¹² This issue was connected to the fate of Derek (and

¹⁰ It is important to notice that both of Shelly's challenges are to the board's behavior, rather than the behavior of a board committee or an agent. It was the board that investigated and punished Derek; the committee gathered the facts, but it made no decisions. It merely presented to the board those facts. In our framework, what was challenged was a board action, and the committee was an advisor to that decision, contributing the information that was the basis for the board's conclusion regarding Derek's behavior. Because the challenge wasn't to the committee directly, it was wrong to apply entire fairness based on *Oracle* (though *Oracle* does matter to the analysis, in eliminating the committee's independence and therefore the board's ability to rely on the committee as an advisor). Also, some students wrongly applied Agency SoR because directors were also agents. Agency SoR was irrelevant here because the challenge was to board behavior, so the individuals acted (and may have breached their FD) as directors, not as agents.

¹¹ Some students wrongly applied enhanced scrutiny, viewing the replacement of a senior employee as affecting control of the firm. This is a mistake. The change of control that invokes enhanced scrutiny is change in shareholder control, not change in which employees have authority within the organization. Therefore, the fact that challenged behavior changes senior employees doesn't invoke enhanced scrutiny.

¹² Some students' BJR analysis used a framework that we didn't study in class, but rather one they probably learned from model answers to old exams (based on how I used to teach BJR analysis several years ago). The current framework treats BJR as a SoR; the old framework treated BJR as a legal presumption. Using each framework entirely on its own yields the same results, but things get confused (and wrong) when the two frameworks are mixed. I'll elaborate on each framework in this footnote so you can recognize the two, but you should only use the new framework (BJR as SoR), because it is less confusing (and you will get wrong answers if you mix elements from both frameworks). The old framework (BJR as a presumption), began with the presumption that the board's business judgment was proper, so the first stage for the plaintiff was to rebut the BJR. This could be done by showing bad faith, or that another SoR applied, but also by showing that there was no business judgement – for example, that the challenge was to an inaction. The next stage (in the old framework) was to decide whether FD was breached, and here there were many different tests depending on the flaw and on whether the challenge was to an action or inaction. It is the complexity of this stage that made me change the way I teach to analyze the BJR – as a SoR rather than a

- indirectly, of Ben), which affects the interests of Derek and Ben’s patrons, Fiona and Carl. Patronage relationships appear similar to friendship, which was insufficient to create a conflict on the board under *Beam*.
- c. Application – Self-dealing: Ben & Fiona’s conflicts don’t turn board action into self-dealing (see 3b), though they undermine board’s reliance on the committee’s work (see 3e).
 - d. Application – Bad faith: To establish conscious disregard of duty that breaches FD, Shelly must show that the board failed to implement any reporting system, or having implemented such a system consciously failed to monitor it (*Stone*). The board had a monitoring system (complaints to the HR officer) and discussed Ben’s complaint. Delegating investigation to a conflicted committee was possibly negligent, but not a conscious failure to monitor.¹³
 - e. Application – Negligence: The board delegated to the Committee to investigate Derek. Under *Oracle*, friendship is enough to create conflict there, so both Fiona (as Derek’s patron) and Carl (as the patron of Ben, who would be promoted if Derek is dismissed) might be conflicted. Because the Committee was conflicted, the board couldn’t rely on the Committee’s findings, which were the sole basis for the board’s investigation and punishment of Derek. The board had the “red flag” of Ben’s complaint (indeed, they thought it sufficiently important to justify an investigation), so delegating the investigation to a conflicted committee is gross negligence. Shelly wins the claim on investigating Derek, but not general oversight of sexual abuse at GGI.

presumption. Under the current framework, BJR isn’t “rebutted” if the challenge is to an inaction (“rebutting” is the refuting of a presumption, something not relevant to the way we use the BJR in our framework). Instead, we ask if the BJR or another SoR applies (that’s the SoR stage), and if BJR applies, we analyze it in a single step (the application stage) with three elements: no negligence (“reasonable investigation” in the case of actions), no bad faith (“legitimate purpose” in the case of actions) and no self-dealing (“good faith” in the case of actions).

¹³ If the board delegated to a conflicted committee, in a manner expected to result in the committee “burying” the issue, this may have been equivalent to failing to monitor. But the board picked two committee members with opposite conflicts – not as good as selecting independent directors, but not a selection that appears intended to make the issue disappear.