

University of Illinois College of Law Examination Cover Sheet

Business Associations

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Number of Pages: 5 (including this page)

Exam Instructions

1. **Accessing and submitting the exam**
 - a. You will take the exam through ExamSoft's Examplify software. You may download and begin the exam at a time of your convenience after 10am on Reading Day (Tuesday of the first week of exams). **You must begin the exam before 10am on the following Monday (Monday of the second week of exams).**
 - b. Once you enter the exam password (which I gave you in the exam prep class) and clicked "Start Exam", you have begun the exam. You will have access to the exam fact pattern and **have 6 hours to complete the exam**. The exam will be submitted automatically when this time limit has passed, if you did not submit the exam earlier.
 - c. If you require assistance while taking the exam, you can contact the law school's helpline by e-mail (law-help@illinois.edu), phone (217-265-5004), or personally (at Classroom J, open during the exam period from 8am to 5pm, Monday-Friday). **Please note that assistance may not be available outside of business hours, and consider this in deciding when to take your exam.** Having a request for assistance go unanswered (or answered late) does not give you a time extension or any other leniency on your exam.
2. **Permissible material:** This is an open book exam. Subject to Instruction 3 (confidentiality), you may use any written materials you want, whether in hardcopy or electronic format.
3. **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.
4. **Anonymity:** The exams are graded anonymously. Do not put on your answer to the exam your name or anything else that may identify you.
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), 1 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.

Julia changes careers: After graduating from Business School, Julia worked at a hedge fund for six years. Most of her job was number crunching: quantifying the expected cash flow of various businesses, and identifying on the basis of this analysis underpriced bonds, which the hedge fund would buy. It was a financially rewarding job and Julia was good at it, but she didn't find this work exciting or meaningful.

When someone else was promoted to a position for which she was also a candidate, she decided to quit her job and pursue her passion: the music business. Julia had an eclectic taste in music, but what she found really fascinating was the music business: how songs earned money, how they became popular, and what might explain which songs became breakout successes and which failed. Julia wanted to find a way to make money out of this knowledge: identify songs that will be successful, buy the rights to those songs, and reap the royalties when the songs were played.

She took a few months to develop a mathematical model to predict the popularity of songs, but the model was not very successful. A few variables were correlated with a song's success (e.g., songs by already famous musicians were more likely to be popular), but everyone in the music industry already knew that, so the rights to such songs were expensive. Julia's model was not outsmarting the market.

A new business model: Julia was about to give up on music and start looking for another hedge fund job. Hoping to get advice and perhaps contacts to find a new job, she met with Ray, who was her mentor at the hedge fund. Ray was one of the hedge fund's founders, but he retired just as Julia quit her job.

Julia lamented her music model's failure, or rather unhelpful success – the songs she identified as likely to be successful were already highly priced. Ray told Julia that he thought she took the wrong approach on making money in music. She shouldn't look for the songs that are most likely to succeed, Ray said, because that was what everyone in the industry was trying to do, and you don't make money fishing in the most crowded area. Instead, Ray suggested, she should look at ordinary songs and see if they can provide a return that's not exciting, but that's higher than the returns on loans of similar risk. The return on each song would not be large, but with enough money invested in enough songs (using borrowed money for most of the investment), even a small extra return could amount to a lot of money.

Julia went back to her spreadsheet, now examining ordinary songs and analyzing them as she used to analyze bonds: quantifying expected cash flows to calculate a song's return (profit from buying rights to the song and collecting its royalties) and volatility (the risk of such an investment). She found that riskier songs offered higher returns – similar to loans. When she compared songs to loans with the same volatility, songs usually offered a better return, especially if you pooled many songs together so that the occasional flops were offset with songs that performed above expectations.

But the extra return from songs over the return on loans was not large; perhaps 2% per year. To make enough money to justify the research efforts, Julia had to manage perhaps \$2M dollars' worth of songs. Julia only had about \$100,000 in savings; not nearly enough to make profits worth her time.

Establishing Vox: Julia sent her spreadsheet to Ray, ostensibly to thank him for his insight, which was proven right by Julia's research. Secretly, Julia hoped that Ray would offer to let her invest some of his money in this venture...

... Which is exactly what Ray did. He replied that he liked the rigor of Julia's analysis and shared it with a wealthy friend, Martha. Ray and Martha offered Julia that together they form a music ownership business called Vox, which will acquire the rights to a pool of songs. Martha would contribute \$1M to the fund and Ray would contribute \$1M. Julia's job would be to identify and buy with those \$2M songs that were expected to earn an annual return above 5%, while the pool as a whole would have an expected volatility (risk) similar to that of BBB-rated bonds (bonds that are just above 'junk bond' rating). Once Julia identified and purchased the songs for Vox, she would manage the pool by collecting the royalties from the songs, selling songs that no longer had a sufficient expected return and using the money to buy new songs with sufficient returns. Julia, Martha and Ray would each own one-third of Vox (essentially, Julia's work would be in lieu of contributing money to the business).

Julia accepted the offer, and prepared a charter that would incorporate Vox as a Delaware corporation. She sent the draft charter to Ray and asked him to show it to Martha, get her consent that it was acceptable, and then file it with the Delaware Secretary of State. Ray said he would do so, and sent it to Martha for review. Martha received the draft charter, but misplaced it and forgot about it. Ray failed to notice that he never received the charter back, and so never filed it with the Secretary of State. Julia failed to confirm with Ray that he filed the charter.

Julia then identified the songs that offered the highest expected return while being sufficiently safe. These tended to be older and less famous songs (so their price was low), but ones that were still reliably streamed or played on the radio, resulting in modest but stable royalties. She identified the current songs' owners, negotiated with them and eventually acquired 50 songs for the \$2M.

Going for ArtGo: Six months later, Julia met with Martha and Ray to report how Vox was doing so far. She was proud to show that in the first half of the year the return on the songs was 4%, so if the next 6 months would be the same, Vox would far exceed the 5% return the investors were expecting. Julia reported that she was about to sell some songs that turned out to be either too volatile or provided insufficient returns. She expected to receive about \$300,000 for those songs, and now needed to reinvest that money.

However, Julia said that she would like to invest it not in other songs, but in stock of ArtGo, a Chinese marble-mining company whose stock was trading in Hong Kong. ArtGo's share price had spiked in recent weeks, making the company so large that it was about to be included in the MSCI China index. Many American and European investors mimicked the MSCI index, so when a company was added to the index, those investors bought shares in the company. Therefore, Julia said, ArtGo's price should rise even higher once it was added to the index.

Julia admitted that investing in ArtGo had nothing to do with Vox's original mission of investing in songs, but she believed such an investment opportunity was too good to miss.

Ray said that he had confidence in Julia's instincts and so would agree to Julia's plan, but Martha did not like the idea of Vox investing in anything other than songs. After they failed to persuade each other, they took a formal vote, with Julia and Ray voting to have Vox use the \$300,000 to invest in ArtGo stock, and Martha voting against.

Following the vote, Julia was going to buy ArtGo stock at the Hong Kong stock exchange, but over a chat with Calvin, a friend from her Business School days, she discovered that Calvin was managing a hedge fund called Integrity, which owned some ArtGo stock. But Integrity was looking to sell the stock because the fund's owner decided that Integrity would limit its investments to US companies.

Julia mentioned that she was in the exact opposite situation: she managed Vox, which was formed to invest in songs, but Vox was now interested in buying ArtGo stock. She told Calvin about the original agreement with Martha and Ray that formed Vox, and about the 2-1 vote they held regarding buying ArtGo [So Calvin knows all of the above facts].

Calvin told Julia that Integrity was willing to sell the stock at a 1% discount to the price it was trading on the stock exchange. Julia and Calvin then agreed that Vox would buy from Integrity \$300,000 of ArtGo stock at a price 1% below what the stock had traded on that day ("the Agreement"). Vox had 5 days to pay, at which point it would receive the shares.

Julia rushed to sell the songs that were marked for disposal and to collect the \$300,000, but it took a few days. On day 2 following the Agreement, the Wall Street Journal had an article that suggested that ArtGo's price was artificially inflated, and quoted several financiers who argued that ArtGo should not be added into the MSCI index since its high valuation was likely the result of fraud. By day 4, just as Julia finished selling the songs and had \$300,000 at her disposal, MSCI announced that it was not including ArtGo in its China index. Following the announcement, ArtGo's price dropped by 98%.

Julia did not send Integrity the \$300,000 (as the ArtGo stock Vox was to receive was now worth only \$6,000). Integrity was about to sue Vox to enforce the Agreement, when it discovered that Vox was never incorporated, and so could not be sued. Integrity therefore sued Julia, Martha and Ray, to require them to honor the Agreement.

(a) **Discuss Integrity's suit.** Integrity did not raise in court, and you should not discuss, the equitable doctrines of estoppel, de facto corporation, and corporation by estoppel.

Expanding Vox: The litigation with Integrity alerted Julia, Martha and Ray to the fact that they never filed Vox's charter. Julia now filed the charter, and Delaware's Secretary of State confirmed that Vox was from that point on a Delaware corporation. Vox's board consisted of Julia, Ray and Martha. Vox allowed another investor – Beth – invest \$1M in return for Vox shares (but Beth was not made a director). Following Beth's investment, Julia owned 30% of Vox, Martha & Ray owned 25% each, and Beth owned 20%.

By the end of Vox's first year, its return was 11% - much above expectations. At a board meeting convened to decide Vox's plans for the coming year, the directors unanimously agreed that Vox should use leverage; in other words, Vox would borrow money (specifically, \$7M), and invest it in more songs. This should be profitable, since the interest Vox would pay would be lower than the expected return from the songs.

Julia said that she couldn't invest \$10M (the \$3M from the shareholders plus the money Vox would borrow) on her own; she would need to hire two analysts to help. Martha & Ray agreed. The board fixed a budget and authorized Julia to hire two analysts. The board also told Julia to review employment laws and make sure to comply with them.

Julia hired Liam (who was Julia's boyfriend) and Ruth. While the analysts worked hard, no one worked as hard as Julia, who felt pressured to outdo last year's success, now that she had more money and a staff at her disposal.

At the end of that year, Julia was proud to present at Vox's shareholder meeting (which was a modest affair, since there were only four shareholders) that Vox's return that year was 19%. Martha and Ray were very appreciative, and Julia felt vindicated.

Dealing with Liam: Julia returned from the meeting straight to Vox's offices to crunch more numbers. While she was working, she received a text from a friend, with a picture taken that evening at a restaurant. In the picture, Liam sat with another woman, and they appeared to be kissing.

Julia was devastated. She texted Liam and asked that he come to Vox's office as soon as possible because they needed to talk. Liam did, and Julia confronted him with the photo she received. Liam admitted that he was seeing another woman. He said that in the past year Julia was spending all of her time at work, and even the few times they were together and not speaking about work, she would be anxious and irritable. He admitted that he should have broken up with her instead of seeing someone behind her back.

Julia said she was willing to forgive him, and she preferred that they stay together rather than break up. She also said he couldn't continue working for Vox if he broke up with her, because she had to have a good relationship with her employees to work effectively.

Liam agreed that they stay together. But a few weeks later, Julia's friend again caught Liam at a restaurant with the same woman. Julia called Liam, broke up with him and fired him from Vox. Liam then sued Vox for having his employment conditioned on dating Julia.

(b) **Discuss Liam's suit.** You should assume that Julia's conditioning of Liam's employment on his dating her, and her subsequent firing of him because he dated someone else, made her liable to Liam in torts (for harassment).

Where was the board?! When Beth heard about Liam's suit, she was upset that Martha and Ray did not do a better job supervising Julia. Her investigation revealed that Martha and Ray didn't know that Liam was Julia's boyfriend, nor did they know about Julia's conditioning of Liam's employment. Vox had no specific policy on romantic relationships among employees, nor one about harassment at work. The board did ask Julia each meeting whether there was anything to report about her analysts, and the directors met twice in the past year with Liam and Ruth, and told them on both occasions that if they had any concerns or problems about anything that was going on at Vox, they should feel free to contact any of the directors to discuss it.

Beth sued Martha and Ray, claiming they breached their fiduciary duty as directors in failing to supervise Julia's conditioning of Liam's employment. (c) **Discuss Beth's suit.**

Model answer for the Fall 2019 BA exam¹

1. Integrity's suit:

- (a) Partnership? When entering the Agreement, Vox wasn't a corporation because its charter wasn't filed. Vox was a general partnership under UPA §202(a), because Julia, Martha & Ray agreed to carry on as co-owners ("each own[s] one-third of Vox") a business for profit (investing in songs).² Co-ownership means shared profits & control; facts indicate sharing profits & shared control in consulting on buying ArtGo. If the partnership was bound to the Agreement, then Julia, Martha & Ray face unlimited liability as general partners.
- (b) Actual authority? As a partner, Julia was the partnership's agent (UPA §301(1)). She would have authority to buy ArtGo stock if the partners approved it. Authorizing matters that aren't in ordinary course of the partnership's business requires unanimity (UPA §401(j)). Julia admitted that buying stock wasn't in ordinary course ("ArtGo had nothing to do with Vox's original mission"), and the vote wasn't unanimous, so Julia lacked authority.³
- (c) Apparent authority? A partnership is liable for a partner's contract made in the ordinary course of the partnership's business (UPA §301(1)). Buying ArtGo isn't in Vox's ordinary course of business (see 1b), which Calvin knows because Julia told him what Vox was formed to do. So no apparent authority.⁴ Under UPA §301(2), partner's act that's not in ordinary course of partnership's business doesn't bind the partnership unless it was authorized by the other partners (who didn't, since Martha objected). So the partnership isn't liable, and therefore neither are the partners.

¹ The music business model is based on: Mischa Frankl-Duval & Lucy Harley-McKeown, *Investors Buy Funds for a Song*, Wall St. J. (Sept. 23, 2019), p. R12. The ArtGo debacle is based on: Xie Yu, *Investors Lose Their Marbles as MSCI U-Turn Spurs 98% Stock Plunge*, WSJ.com (11/21/19).

² In some cases, there could be a dilemma whether a relationship is a partnership or agency, but not here. Julia is clearly not an agent of Martha and Ray, because if she were their agent, she would not share control, but rather have a duty of obedience to her principals. Because in this case she shares control rights (indeed, equal control rights to Martha and Ray), this is a partnership, not an agency for Martha & Ray.

³ Some students wrongly applied the Restatement's general rule on actual authority rather than RUPA §401(j), to find that a majority vote created authority in this case, since Julia believed she was receiving authority from a corporation, where a majority vote of the board (rather than unanimity) would suffice. As a matter of positive law, RUPA's statutory rule supersedes general agency common law rules, since it is more specific (to partnerships). As a policy matter this is also sensible, as a reasonable actor should know the authority-granting rules that apply to the entity they represent.

⁴ Some students applied the Restatement's general rule on apparent authority rather than RUPA §301, to find apparent authority because Calvin reasonably believed that Vox was a corporation (and thus the majority vote could authorize Julia). Again, as a matter of positive law, RUPA's specific rule should supersede the general common law rule. However, here the policy considerations are more supportive of the argument than with actual authority, because apparent authority is designed to protect third parties, who aren't in as good a position as the actor to reasonably know the entity they are dealing with. So, while I think that positive law would still require applying RUPA (and finding no apparent authority), I gave credit to students who decided that the agency law rule governed apparent authority, as long as they first identified and analyzed the RUPA rule, and then stated that it was superseded by the common law rule on apparent authority.

- (d) Julia's liability: Julia is an agent to a disclosed principal (Vox, a general partnership), and therefore not party to the Agreement (R3A §6.01).⁵ However, she's liable to Integrity for breaching her implied warranty of authority (R3A §6.10), unless she shows that Integrity knew she lacked authority (which is unlikely because Calvin believed that Vox was a corporation, so the majority vote Julia told him of should have sufficed. Julia is liable to Integrity.

2. Liam's suit:

- (a) Authority: Julia clearly wasn't authorized to condition Liam's employment on his dating her. As the senior (and initially, only) worker at Vox, Julia manages the song portfolio on Vox's behalf and is subject to the control of Vox's board, and thus is Vox's agent (R3A §1.01).⁶ The board instructed Julia to hire two analysts, and authority to fire and condition the hires could be incidental to this (R3A §2.02(1)). But the board also manifested that she "comply with [employment law]", which can't support reasonable belief that she could condition employment on a personal relationship.
- (b) Respondeat Superior: Julia is probably an employee. As Vox's portfolio manager, she acts on Vox's behalf. She has a lot of discretion, and this task requires special skills that Vox's other directors don't have, so perhaps Vox doesn't control the manner and means of her work, making Julia a non-employee. But usually in corporations, employees engaged in core activities are obligated to follow the board's micromanagement, and if this is the case with Vox (even if the board chooses not to micromanage) then Julia is an employee. Julia is likely not within SoE. Hiring and firing employees was subject to board's supervision so she's within SoE under the control test, but her purpose was personal: to keep dating Liam. However, if she was sincere in saying the conditioning was because "she had to have a good relationship with her employees to work effectively", then like *Manning* this was within SoE under the purpose test. Also, conditioning the employment can be seen as a direct outgrowth of the board's instructions to hire analysts, making it within SoE as in *Lyon*.
- (c) Apparent authority: Vox is liable under R3A §7.08 because actions taken with Julia's apparent authority (her position as the portfolio manager, which Liam could reasonably believe allowed her to fire him or set conditions for his continued employment) constituted the tort (harassment through the conditioning of his employment on an intimate relationship).⁷

⁵ Applying R3A §6.01 is a better answer than applying R3A §6.04 (claiming that Julia was an agent to a non-existent party – the corporation Vox), because Vox exists (it is just a partnership rather than a corporation). But the outcome is likely the same: if we applied R3A §6.04, Julia and Integrity are parties to the Agreement and Julia is liable.

⁶ While Julia is also a director of Vox, her hiring, conditioning and firing Liam aren't done as a director but as an employee: individual directors don't act on a firm's behalf; only the board or a board committee does, and the board did not create a committee consisting solely of Julia.

⁷ While tort liability based on apparent authority is most common in cases of misrepresentation, conversion and defamation, these are not an exclusive list. Some students argued that Liam could not reasonably believe that Julia was authorized to fire him for cheating on her. Note that what matters is not whether Liam reasonably believes Julia acts unlawfully or tortuously (even if he does, this does not eliminate

- (d) Negligence: Probably no breach (other elements are satisfied).
- i. Duty: Vox owes Liam a DoC under R3A §7.05(1) & R3T §41(b)(3) because the risk of harassment by a supervisor was facilitated by Julia's employment.⁸
 - ii. Breach: The board instructed Julia to comply with employment laws, and encouraged employees to contact any of them with problems. Vox had no harassment policy, and didn't actively monitor harassment, but it was a small company, and neither Julia nor the company had harassment problems in the past that would indicate need for more director attention. Probably reasonable directors wouldn't have done more, so no breach.
 - iii. Causation: If the board was careless in monitoring Julia (contra 2d(ii)), this carelessness allowed Julia to wrongfully condition Liam's employment.
 - iv. Damages: Liam was harmed by conditioning his employment on his dating Julia (and subsequently losing his job for dating another person).

3. Beth's suit:

- (a) **Duty:** Martha and Ray owe Vox a FD as directors.
- (b) **SoR:** BJR. Martha and Ray don't receive a personal benefit from failing to supervise Julia and aren't dominated by Julia (even if Julia has a personal interest in less board supervision, Ray's mentorship is less than the friendship that was insufficient to create domination conflict in *Beam*). So the majority of directors (2 of 3) are independent and entire fairness doesn't apply.⁹ The board's alleged failure to supervise also isn't a CoC or encroachment on SH rights, so enhanced scrutiny doesn't apply.

apparent authority). What matters is whether Liam reasonably believes he is fired, as far as Vox is concerned, when Julia tells him he is fired (i.e., belief that Julia speaks for the firm). As a counter-example, suppose that Liam annoyed Ruth and Ruth told him he was fired. Liam would likely keep coming to work, believing that the company would not view him as fired just because Ruth (who is not his boss) purported to fire him. Back to our exam, as long as Liam reasonably believes that following Julia's call he was in fact fired, then there was apparent authority. In contrast, if he reasonably keeps showing up to work in the belief that the Julia's call didn't affect his employment status, then there wasn't apparent authority.

⁸ The employee-employer "special relationship" doesn't create a DoC that's relevant in this case. R3T §40(b)(4) defines the special relationship as between "an employer with its employees who, while at work, are: (a) in imminent danger; or (b) injured or ill and thereby rendered helpless". These are irrelevant to Liam's case.

⁹ There's no constructive conflict here. If the board was sued for approving Liam's hiring, then Julia's failure to inform that Liam was her boyfriend would cause the other directors to be constructively conflicted (to prevent Julia from benefiting from hiding this information and getting the hire approved). But the board is sued for failing to supervise. It's not clear that Julia had a duty to disclose her relationship with Liam, given that there isn't an action the board is taking to which this information is material. Furthermore, constructive conflict is a rule designed to prevent the person owing a duty of disclosure from benefitting from the breach; the constructively conflicted directors are not seen as acting wrongfully. In contrast, here the only issue is whether the directors acted wrongfully, and Julia doesn't benefit from applying a more deferential SoR to the suit against Martha and Ray. If we viewed this situation as creating constructive conflict, every suit alleging a board's failure to monitor employee wrongdoing would be analyzed under entire fairness (since the wrongdoer would not have reported the wrongdoing to the board).

(c) **Application:** Negligence is exculpated (since if it occurred it was unintentional, defendants are directors, and suit is for damages not an injunction). No conscious illegality because directors didn't know of Julia's conditioning of Liam's employment and didn't act to endorse it. No conscious disregard of duty (*Caremark* liability): Board had an informal reporting system of asking employees to contact directors with concerns or problems, so it didn't "utterly fail[] to implement any reporting... system", and board received no warning, so didn't "consciously fail[] to monitor [the system's operations]". (*Stone*).