

# University of Illinois College of Law Examination Cover Sheet

## Business Associations

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Number of Pages: 4 (including this page)

### Exam Instructions

1. **Accessing and submitting the exam**
  - a. The exam form will be e-mailed to you by my administrative assistant, at 10am CST on Tuesday, Dec. 8 (Reading Day).
  - b. Save your exam answer as a Word (.doc or .docx) file, with the file name being your 4-digit exam number.
  - c. Submit the exam by e-mailing it as an attachment to my administrative assistant Kelly Downs (kdwns@illinois.edu). **You must submit the exam by 9:59am CST on Monday, Dec. 14.**
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 in your exam answer anything that may identify you, except for your 4-digit exam number.
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.

**Other People’s Money:** Oliver, Penelope and Maya became friends in college, and later pursued different careers but stayed in touch. Decades later, all three were retired and affluent, and wanted to invest and continue to grow the money they had saved. They formed a Delaware corporation called Other People’s Money (“OPM”) and put most of their savings into the company. Oliver owned 30% of OPM’s single class of shares, Penelope owned 45%, and Maya the remaining 25%. OPM’s charter set the number of directors at 3, and Oliver, Penelope and Maya were its directors. Maya was also OPM’s CEO, while Oliver and Penelope did not hold any position at OPM other than directors. OPM’s bylaws state that the CEO “manages day-to-day operations of the company”.

OPM operated like a private equity firm: Maya and her staff would identify promising investments – often businesses that had obvious problems and were therefore cheap, but that OPM believed could be quickly “fixed”. Maya would bring the most promising investments before the board and get the board’s approval to acquire them.

If the board approved an investment, Maya would have OPM acquire the business. To increase profitability, OPM would leverage its acquisitions: it would borrow about 80% of the purchase price from banks and use its own funds to cover the remaining 20%. Naturally, OPM had to pay interest on the borrowed money, so it had an incentive to pay back the bank loans as quickly as possible. To do this, it would make the companies it acquired sell non-core assets, borrow money and distribute the resulting cash as dividends to OPM. OPM would then use the dividends to pay down the loans.

**GreatGames becomes GreatFlix:** Maya’s staff identified a promising investment: a publicly traded Delaware corporation called GreatGames. GreatGames produced a variety of games, some of which were well-known. While it had a loyal customer base, it had not been growing in a long time. Its production costs have been creeping up, and young people preferred playing on the internet rather than with GreatGames’ physical games, so its customer base was shrinking. Because of this, GreatGames’ stock was trading at very low prices.

Maya presented this investment opportunity to OPM’s board. She argued that GreatGames’ business could be turned around if it shifted from making games to making movies about the characters and settings of its well-known games. The board was persuaded and approved the acquisition. OPM made an offer to buy the company from the public for \$100M. It took a bank loan for \$80M and used \$20M of its own funds. The transaction closed successfully and GreatGames was now fully owned by OPM. To signify the planned conversion of the company into an independent movie producer, the company changed its name from GreatGames to GreatFlix.

Initially, Maya was GreatFlix’s CEO and sole director. She sold GreatFlix’s game factories for \$60M and signed contracts to have the buyers of the factories continue to produce the games for GreatFlix (i.e., she outsourced the production of the games). She also had GreatFlix take a \$40M long-term loan from a bank.

GreatFlix now had \$100M in cash. Maya’s staff next calculated how much money GreatFlix would need to develop its movie business. They determined that GreatFlix would need about three years to become profitable, and during this time, it would need to spend up to \$40M.

Maya decided to leave \$20M in GreatFlix and distribute the remaining \$80M to OPM as a dividend. OPM used this money to pay back the entire loan they took to buy GreatFlix.

After this restructuring, OPM maintained “hands off” ownership and did not intervene in GreatFlix’s business, nor draw additional dividends from GreatFlix. Maya recruited directors for GreatFlix who had expertise in the movie industry, and they replaced her on GreatFlix’s board. The new directors hired Dan, also a movie industry veteran, as GreatFlix’s CEO. The company then began to develop movies based on GreatFlix’s well-known games.

**Desperately needing money:** The following two years heaped disappointment after disappointment on GreatFlix. Movie production costs turned out to be more expensive than anticipated. The first movie was a flop, and the company decided to spend more to get experienced talent. The next movie received positive reviews from critics, but just as it was about to start showing in theaters, the Covid-19 epidemic erupted and shut down movie theaters. GreatFlix tried to distribute its movies online, but it did not develop a reputation yet, so few people chose to watch its movies.

GreatFlix’s board decided it needed to double down on their bet on movies, trying to produce a blockbuster by hiring more famous actors and advertising heavily. But they had already used up almost the entire \$20M of cash they had.

Dan met with Maya, explained the situation to her and asked OPM to lend GreatFlix \$25M to help it survive through the epidemic. Maya told Dan she would bring this up at OPM’s next board meeting. At that meeting, Maya said that there’s a real risk that OPM would lose any additional money they lent, but that if they let GreatFlix fail, it would hurt OPM’s reputation and demoralize employees in other companies OPM owned. Oliver agreed, but Penelope was adamant that OPM should not throw more money into an investment that she now claimed was a mistake. Maya and Oliver decided not to force the issue. Maya then called Dan and told him that GreatFlix needed to borrow the money from someone else.

Dan turned to several banks seeking a loan, but they all declined to invest in a company with a fragile financial situation, in an industry that was being rocked by the epidemic. Dan seemed on his way to yet another rejection when he had a Zoom meeting with Greg, a senior employee of First National Bank (“FNB”). Greg explained that he would love to lend to independent movie producers such as GreatFlix since he is optimistic about the movie industry’s long-term future, but the economy was currently volatile and difficult to predict. Greg suggested FNB might lend the money if GreatFlix’s shareholder, OPM, guaranteed the loan (i.e., promise that if GreatFlix didn’t repay FNB, then OPM would).

Dan immediately called Maya and asked her to join the Zoom meeting with Dan and Greg. Maya joined, and Greg asked if OPM would guarantee repayment of a \$25M loan to GreatFlix. Maya said OPM would do so.

But Greg said he was still not sure if FNB should lend the money given Greatflix’s precarious financial situation. He then gushed about how much he loved the movie industry. “When I was young, I wanted to become an actor, but I couldn’t break in,” Greg said. “Now my daughter wants to be an actress, but she can’t land her first job”.

“We can help,” Maya said. “GreatFlix would be happy to give your daughter a role in their next movie... if they are financially able to produce a movie. Right, Dan?”

Dan nodded. Greg smiled and said: “We have a deal, then.”

Later that day Greg e-mailed Dan and Maya, documenting their understanding at the Zoom meeting: FNB would lend \$25M to GreatFlix, and OPM would guarantee the repayment of the loan. The e-mail listed the loan’s terms, including that if GreatFlix stopped producing the movie before its completion, the loan would be considered in default and must be repaid immediately. The e-mail even mentioned that GreatFlix would hire Greg’s daughter for an acting role in their next movie.

Dan replied “GreatFlix agrees.” Next, Maya replied “OPM agrees.”, sending the e-mail not only to Dan and Greg, but also to Oliver. Oliver then replied to Maya, Dan and Greg that Maya explained the situation to him, and that OPM agrees to the terms in Greg’s e-mail.

Greg checked available records and confirmed that Maya and Oliver were two of the three OPM directors, and together owned 55% of OPM’s shares, and that Maya was CEO of OPM. Satisfied, he e-mailed “FNB agrees” and authorized the transfer of \$25M to GreatFlix. GreatFlix began producing another movie and gave Greg’s daughter a minor role in it.

**To no avail:** But the Covid-19 epidemic continued to torment GreatFlix. Multiple times, an actor or worker tested positive and required the entire cast to quarantine, stretching production times. A leading actress became seriously ill and had to drop out, requiring re-filming many scenes with a replacement. GreatFlix burned through the \$25M it received from FNB and had not yet completed the movie.

When another actor reported contracting the disease and health authorities required the cast to quarantine for another 14 days, Dan called Maya and told her that either OPM lent GreatFlix another \$5M to complete the movie, or they would have to terminate it.

Maya called a board meeting and reported the news from Dan. Penelope insisted that they do not sink any more money into GreatFlix. Maya and Oliver were also starting to sour on the company’s prospects. They agreed they wouldn’t lend GreatFlix any money.

Maya informed Dan, who then terminated the movie. When FNB learned that the movie was terminated, they said the \$25M loan was in default and demanded that GreatFlix repay it immediately. But GreatFlix had no money at all, and its remaining assets would not be enough to pay its debts. FNB sued OPM, demanding that OPM pay the \$25M that GreatFlix borrowed from them. **Discuss FNB’s suit.**

## **Model answer for the Fall 2020 BA exam<sup>1</sup>**

FNB has three viable paths to hold OPM liable for GreatFlix's \$25M debt: as guarantor of GreatFlix's loan, by veil piercing, or for aiding and abetting Greg's breach of FD to FNB through Maya's offer of the "bribe" of Greatflix hiring Greg's daughter.<sup>2</sup>

### **1. Loan guarantee:**

- (a) Did Maya's verbal agreement on the Zoom meeting bind OPM? As CEO, Maya is OPM's agent, managing operations on OPM's behalf and subject to the board's control (R3A §1.01). As a director, she has no authority to act on OPM's behalf. Can Maya reasonably believe from OPM's manifestations that she's authorized to guarantee a subsidiary's \$25M loan (R3A §3.01)? Probably not. Bylaws manifest authority to "manage day-to-day operations"; the \$25M potential liability doesn't seem "day-to-day".<sup>3</sup> OPM's past practice of getting board approval for both stock acquisitions and loans (including one of the same \$25M scope) manifests that a \$25M guarantee also requires board approval.
- (b) Apparent authority: Greg received manifestations from OPM (through the record check) that Maya is CEO and director of OPM. A reasonable experienced banker knows corporate law gives directors no authority to act on their firm's behalf, and industry norms give CEOs authority to manage the ordinary course of the firm's business. I think a reasonable banker would believe a \$25M subsidiary loan guarantee is not ordinary course due to the large scope of potential liability, but

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<sup>1</sup> The self-dealing situation is very loosely based on: *U.S. v. Sadleir*, (S.D.N.Y.; complaint May 18, 2020).

<sup>2</sup> Some students considered liability based on arguments that GreatFlix was OPM's agent or partner. I believe neither of these is even remotely possible, so I did not consider either of them to be an issue. In its interactions with FNB, GreatFlix acted as an independent firm – it was not borrowing money on OPM's behalf, nor for a business jointly operated by OPM and Greatflix. OPM's benefit from the loan and the firm production it facilitated was only indirect, caused by its ownership of Greatflix's shares. So, there's no "acting on B's behalf" and no "shared profits" (per the agency and partnership tests).

Likewise, at the time GreatFlix interacts with FNB, OPM does not assert direct control over GreatFlix (beyond their right as shareholders to elect GreatFlix's board). So, there's no "subject to B's control" and no "shared control". A few students also alleged tort liability based on Maya's alleged misrepresentation to FNB that she was authorized to make OPM guarantee GreatFlix's loan. If this was correct, every contract liability case would turn into a tort liability case (since they always involve the actor purporting to have contractual authority to bind the beneficiary), and torts would become a "back door" to hold B liable for contracts A did without actual or apparent authority, since A would be seen as tortuously "misrepresenting" their authority. In the context of the exam, a tortuous misrepresentation (that OPM may be liable for) would occur if Maya gave FNB false financial information on GreatFlix to induce them to lend. But Maya's claim that she has authority to contractually bind OPM is assessed under contractual liability, not tort liability.

<sup>3</sup> Some students incorrectly applied the R3A §2.02(1) test of "necessary or incidental to achieving the B's objectives" and found authority for Maya to do anything necessary or incidental to any of OPM's objectives. This is too broad, as it would mean, for example, that a low-level employee would have authority to sign a contract to borrow \$25M for their employer, if borrowing the money was necessary for the business as a whole. In fact, the R3A §2.02(1) test only authorizes actions that are necessary or incidental to achieving B's objectives in the agency relationship with that particular agent. So, in Maya's case, she would have authority to do anything necessary or incidental to the day to day operation of OPM. Generally, R3A §2.02(1) operates to expand authority derived from other sources, so that when you identify manifestations from B to A that make A reasonably believe she is authorized to do a particular act, the test further expands the authority to anything necessary or incidental to that particular act.

it's less clear than the actual authority analysis. Greg also sees Oliver's e-mail, but the two e-mails do not amount to board action (see 1c), and directors as such don't normally have authority to make manifestations on their firm's behalf, so Oliver's e-mail is not OPM's manifestation.

Estoppel is also questionable: OPM does detrimentally change position (lending GreatFlix \$25M) based on OPM's guarantee. OPM's culpability is uncertain: Maya intentionally caused FNB's belief, but it's not clear her intention (to act without authority) can be attributed to OPM, and the same goes for her notice that FNB was induced to change its position. It's also questionable whether FNB was justifiably induced: the analysis is similar to that of reasonable belief in 1b above, except that Oliver's e-mail can now also be considered since estoppel does not require that the justifying circumstances come from OPM. Still, this doesn't seem ordinary course and boards can only act through a valid meeting or consent, so probably no estoppel.

- (c) Since Maya and Oliver are both directors and shareholders, the e-mail exchange that includes their approvals of OPM's guarantee may be a written consent, either in lieu of a SH or board meeting. However, a SH meeting lacks the authority to guarantee a loan, since this is part of the board's plenary authority to manage "the business and affairs" of the company (DGCL §141(a); *Gorman*).

Conversely, the board has authority to guarantee loans under its plenary authority (DGCL §141(a)), but the e-mail exchange fails to be a valid consent since board consents require unanimity (DGCL §141(f)), and Penelope didn't participate here.<sup>4</sup>

Conclusion: OPM is not liable to FNB as a guarantor of the \$25M loan.

## **2. PCV:**

FNB can PCV to hold OPM liable for Greatflix's \$25M obligation, if it can demonstrate unity of interest between Greatflix and OPM, and an injustice from not piercing the veil.

- (a) Unity of interest: OPM observed formalities and treated Greatflix as a separate entity, with separate directors, staff and assets. However, when restructuring Greatflix, OPM (through Maya's management) siphoned assets from the debtor (Greatflix) to the defendant (OPM), knowingly undercapitalizing Greatflix by

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<sup>4</sup> Many students analyzed the effect of the Oliver's and Maya's e-mails as ratification rather than authorization through a written consent. I believe the action is an authorization and not a ratification because I think the contract was only formed after Greg agreed by e-mail, and thus there was not yet an unauthorized contract to ratify when Oliver and Maya wrote their e-mails. But I did not consider analyzing the action as ratification a mistake, and the analysis of the legal impact of the e-mails would be the similar whether they are an authorization or a ratification. In both cases, one needs to assess whether the approver had authority to approve (as a board they do, as a shareholder meeting they don't), and whether the e-mails amounted to an action to approve (as a board consent, it didn't). Some students also considered whether the board implicitly ratified the contract later, but there was no board action in the fact pattern that related to the loan guarantee, ratification through acquiescence to a contract that does not give direct benefits to B is at best ambiguous (it does not amount to B's acceptance of the benefits of the bargain), and the fact pattern does not indicate that Penelope knew of the guarantee, so the board was not informed.

leaving \$20M when it estimated Greatflix may need up to \$40. This can form a unity of interest even when done as legal dividend distributions.

- (b) **Injustice:** FNB is a contract creditor; it chose to become Greatflix's creditor. Therefore, an injustice requires that OPM's actions creating a unity of interest prevent FNB from contractual protection against default. Because FNB lent the money after OPM undercapitalized Greatflix, FNB could contractually protect itself (e.g., by refusing to lend, or asking for a shareholder guarantee, as it did) (analogy to *Metropolitan Life*).

Conclusion: The unity of interest didn't cause an injustice to FNB, so its attempt to PCV from Greatflix to OMB will fail.

### **3. Aiding & abetting FD breach:**

- (a) **Fiduciary relationship:** Greg owes FNB a FD as an agent if he acted on FNB's behalf and subject to FNB's control (R3A §1.01). He is described as a "senior employee", and an employee is a sub-type of agent who acts on the employer's behalf and subject to the employers control (even as to the manner of work), so Greg is an agent and owes FNB a FD.
- (b) **Breach:** As an agent, Agency SoR applies. Greg was self-dealing in accepting the "bribe" of Greatflix giving his daughter an acting role. FNB wants to lend to Greatflix only if the benefits outweigh the risks, but Greg has a personal interest of lending to Greatflix in any case, so that his daughter gets her first acting job. Under Agency SoR, any act tainted with self-dealing breaches FD.
- (c) **Knowing participation:** Probably. Maya (representing OPM) suggests the bribe, but it is Greatflix (and Dan), not OPM, that are actually hiring Greg's daughter and thus bribing. Maya's involvement in the bribe is certainly "knowing": she knows that Dan is FNB's agent and by accepting the bribe he would be breaching his FD. But is she (and OPM) "participating" in the bribe? Since Maya is acting in the negotiations on behalf of OPM, and since OPM is a party (as a guarantor) to an agreement that includes in its terms the bribe, I believe a court would rule that OPM "participated" in the bribe.
- (d) **Damages proximately caused by breach:** But for the bribe, Greg may not have lent Greatflix \$25M, which are now unrecoverable from Greatflix, so damages amount to \$25M.

Conclusion: OPM may be liable to FNB for \$25M, if Maya's suggestion of a bribe amounts to OPM's "participation" in the bribe (which is probable but not certain).