

# University of Illinois College of Law

## Examination Cover Sheet

### **Business Associations**

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Fall Semester 2022

Exam length: 3 hours

Number of Pages: 4 (including this page)

### **Exam Instructions**

1. **Permissible material:** This is an open book exam. Subject to Instruction 2 (confidentiality), you may use any written materials you want, whether in hardcopy or electronic format.
2. **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) may be a person who has seen the exam.
3. **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.
4. **Answering the exam:** Cite relevant case and statutory authority. Answer all relevant issues that arise from the fact pattern, even if your conclusion on one of the issues is dispositive to other issues.
5. **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 business entity's charter states that: the entity is a stock corporation, has limited liability and perpetual existence; the entity 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 business entity'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.
6. **"Fact" patterns are fiction:** The "facts" presented in this exam are not necessarily true in real life.

Sam was a tech whiz who wanted to change the world. He developed the code for a new cryptocurrency called Virtue, which did not require energy-intensive “coin mining”, and therefore, he believed, was more environmentally friendly than any other cryptocurrency.

Sam had another revolutionary idea – a decentralized alternative to the corporation, in which technology would allow to do away with intermediaries such as directors and managers, and allow the owners to directly manage the business. He called this revolutionary entity Virco (short for Virtue Company), and created the Virco App, software that could be uploaded on a phone or other device, and would authenticate the owner’s fingerprint and allow them to vote on management decisions.

Sam wrote the Virco Constitution (the “Constitution”), which gave the details of the governance of Virco. The first principle was that Virco was owned and managed by the owners of the Virtue coins (“Coinowners”), and they each had as many votes on management decisions as the number of Virtue coins they owned. The Constitution stated that anyone accepting ownership of Virtue coins was thereby accepting being governed under the rules of the Constitution.

The code for Virtue coins determined (and updated according to an algorithm) the maximum number of Virtue coins that could be issued. As long as that maximum number wasn’t reached, Virco could issue new Virtue coins. Instead of dividends, the Constitution allowed Virco to distribute profits to Coinowners by using the profits to buy back Virtue coins (at a higher price reflecting the profits that were being distributed). Virco could also buy back Virtue coins for any other reason. The Constitution stated that if Virco was dissolved, all assets remaining after paying debts would be divided between the Coinowners according to the number of Virtue coins they owned.

The Constitution also stated that the management of Virco was to be done by the Coinowners, by voting on decision proposals using the Virco App. Virco would have a single officer, called the Servant, who would be elected by the Coinowners. The Constitution stated that the Servant was responsible for proposing (at the Servant’s complete discretion) what actions Virco should take. The Servant would then enter a proposal into the Virco App, which would then alert all Coinowners that they could vote on the decision. Voting would be open for 24 hours, after which it was the Servant’s responsibility to execute on Virco’s behalf any decisions that had more votes in favor than votes against. The Servant is required to abide by the outcome of the vote, and may not act on Virco’s behalf without Coinowner authorization.

Sam didn’t file the Constitution, or any other document regarding the formation of Virco, with the Secretary of State of any state. He bought from Virco the first 10 Virtue coins.

Sam wanted to raise Virtue’s profile by getting celebrity endorsement. He contacted E\$\$ie-C, a rapper whose real name was Ester Collins, and whose songs were famous for protesting, in colorful language, against bad corporate governance. Sam explained to Ester the innovations of Virtue coin and of Virco, sent her the Constitution, and asked if she’d be willing to accept 10 Virtue coins, at no cost other than Virco being allowed to publicize that E\$\$ie-C owns Virtue coins. Ester agreed. Sam then held a Virco App vote that approved Sam’s appointment as Servant.

Sam moved to the next step, which was boosting Virco's reputation as a FinTech (financial technology) company. He updated the Virco App so it could also be used as a digital wallet that allowed users to pay at stores using funds deposited with Virco ("Virco Wallet"). Since Virtue coins were still unknown, Sam's plan was that Virco would accept deposits of Bitcoin (a well-known cryptocurrency). Users of the Virco Wallet would deposit Bitcoin with Virco, and then use the Virco App to pay at stores, with Virco paying the store and deducting the payment (plus a small transaction fee) from the user's deposit. The terms of service stated that the user (not Virco) owned the deposited Bitcoin, though possession and control of the Bitcoin was transferred to Virco so that it could charge the deposits when users made payments. Sam proposed to the Coinowners his Virco Wallet plan, and they approved it. He had Virco launch this service, and within a few months Virco accumulated \$10M worth of Bitcoin deposits.

Virco's celebrity endorsement and the Virco Wallet got people interested in Virtue coins, and soon many people bought from Virco newly issued new Virtue coins. Sam's 10 coins were now less than 1% of the total coins issued.

Sam became famous thanks to the growing popularity of Virtue coins, and various tech entrepreneurs approached him to see if he would invest in their ventures. One such venture looked particularly promising: Laundroid LLC ("Laundroid"), a start-up that was developing a prototype robot (also called Laundroid) that folds your laundry.

Sam decided not to seize this potentially profitable opportunity for himself, and instead offered that Virco use the cash it had from coin issuance to invest in Laundroid. He proposed this via the Virco App, the Coinowners approved, and Virco invested most of its cash in Laundroid.

Laundroid completed the prototype, tested and improved it and... it was a dud. It took 10 minutes for the robot to fold a single T-shirt, and the cost per unit was about \$16,000. Virco's investment in Laundroid appeared to be worth very little now, which meant that there Virco had few assets to back the value of Virtue coins. The price at which Virtue coins were trading plummeted.

To raise the price of Virtue coins and restore confidence in them, Sam wanted Virco to buy back some coins. However, Virco had almost no money left. Sam desperately sought someone who would be willing to lend money to Virco. After several potential lenders turned him down, he contacted Iman, the CEO of Aurum Corp. ("Aurum"), a Delaware corporation that was an investment fund. Sam was a director at Aurum. He asked Aurum to lend money to Virco.

Iman said such a loan was too risky and asked if Virco had any assets to sell. Sam suddenly remembered the Bitcoin deposits. He knew that they belonged to the Virco Wallet users, not to Virco, but believed Virco's survival was at stake and depended on using any resource available to restore confidence in Virtue coins.

He told Iman that Virco had \$10M worth of Bitcoin. Iman offered to buy the Bitcoin for \$9M. Sam believed he couldn't get a better price without spending a day or two shopping for better offers, and also believed that Virco would not survive if it didn't get cash and buy Virtue coins within the next few hours, so he agreed. Because of the same time pressure, Sam believed that Virco could not afford to wait 24 hours for a vote to take place, so he did not set up a vote on the Virco App, and simply transferred the Bitcoin to Aurum and had Virco receive \$9M in return. Iman (and therefore Aurum) was aware of the content of Virco's Constitution, the fact that Sam was elected as Virco's Servant, that he was a director at Aurum, and that he owned Virtue coins. Iman (and therefore Aurum) was not aware that the Bitcoin wasn't Virco's property, nor did she know whether Sam received Coinowner approval for the Bitcoin sale.

Virco used the \$9M to buy back Virtue coins, which boosted their price. However, news of Virtue coins' earlier drop in price caused users of the Virco Wallet ("Depositors") to worry about their deposits and ask to withdraw their Bitcoin. Virco had no Bitcoin, and by now spent all of its cash buying Virtue coins, so it couldn't return the deposits. Assume that by selling the Depositors' Bitcoin to Aurum, Sam committed the tort of conversion against the Depositors. The Depositors sued Ester to recover the value of their Bitcoin deposits. The Depositors conceded that Virco was not negligent in appointing, supervising or otherwise controlling Sam.

Sam resigned from his position as Virco's Servant and the Coinowners elected another person (Roy) as the new Servant. Roy proposed to the Coinowners that Virco should sue Aurum. The Coinowners approved, and Virco sued Aurum in connection with Sam's sale of the Bitcoin to Aurum. Virco's suit, however, conceded that Sam had apparent authority to sell the Bitcoin to Aurum. Virco's concession regarding Sam's apparent authority only applies to the suit between Virco and Aurum and does not apply to the Depositor's suit against Ester.

**Discuss the Depositors' suit against Ester and Virco's suit against Aurum.**

## **Model answer for the Fall 2022 BA exam**

### **1. Depositors v. Ester:**

Ester would be liable for Sam's tort if Virco is liable for Sam's tort, Virco is a general partnership, and Ester is a partner in Virco with unlimited liability for Virco's obligations.<sup>1</sup>

- (a) **Virco is a general partnership:** A partnership is an “association of two or more persons to carry on as co-owners a business for profit” (UPA § 101(6), 202(a)). Once Ester accepts the Virtue coins, there are two people involved. The business is for profit (since profits can be distributed to Coinowners by buying back coins, or distributed to them when Virco is dissolved). Co-ownership means sharing control and sharing profits. Virtue Coinowners share in Virco's profits because they have a pro rata claim to all of Virco's retained profits when Virco is dissolved. The Coinowners share in controlling Virco because the Constitution states that “the management of Virco was to be done by the Coinowners, by voting on decision proposals using the Virco App”. From the point that Ester becomes the second Virtue Coinowner, and while there are at least two Coinowners, Virco is a general partnership and each Virtue Coinowner is a partner in it. Ester (and perhaps most or all of the Coinowners) each have only a small share of the total vote, but as we learn from *Day*, having an very small share of the vote and profits does not eliminate the fact that control and profits are shared, and that the person who has a share of control and profits is a partner no matter how small that share is.
- (b) **Sam is Virco's agent,** both because he is a partner (partners are agents of the partnership when acting for the purpose of partnership business (UPA §301(1))), and because (under the test in R3A§1.01) as the Servant he administers votes and executes their outcomes on Virco's behalf, and is subject to Virco's control in having to abide by the outcome of the votes of Virco's partners (the Coinowners).
- (c) **Actual authority:** Under R3A§7.08, a principal is liable for an agent's tort when the agent's tortious conduct “is within the scope of the agent's actual authority...”. Since the sale of the Depositors' Bitcoin was a tort, Virco would be liable if Sam had actual authority to sell it to Aurum.

Sam would have authority to sell the Bitcoin deposits on Virco's behalf if a manifestation by Virco, perceived by Sam, made Sam reasonably believe that he is

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<sup>1</sup> A correct analysis needed to explicitly establish both Virco's liability for Sam's tort, and Ester's liability for Virco's tort obligation. Some students showed that Ester has unlimited liability as a general partner, but wrongly asserted that this (in itself) made her liable for Sam's tort, rather than show that Virco is liable for Sam's tort. This cut the connection between the Sam's tort and Ester, since a general partner has unlimited liability for the partnership's obligations, not the obligations of another partner. Other students made a similar mistake by ignoring the general partnership and examining Ester's liability for Sam's tort as if Sam was Ester's agent. But Sam was not Ester's agent; he clearly acted for Virco and not for Ester individually. Yet another mistake considered Ester as an actor (for Virco or for Sam) and applied the “corporate compliance” contract or tort framework. This is wrong both because none of the facts have Ester interact with third parties on Virco's behalf, and because, even if Ester had acted on Virco's behalf, the Depositors were not trying to hold Virco liable for an act Ester did (which is what that framework would have addressed), but to hold Ester liable for something Sam did.

authorized to sell the Bitcoin deposits on Virco's behalf (R3A§2.01). The relevant manifestations are that Sam was elected as Virco's Servant, and that the Constitution states that "the management of Virco was to be done by the Coinowners, by voting on decision proposals using the Virco App", and that "The Servant is required to abide by the outcome of the vote". This could not have made a reasonable agent believe they could sell the Bitcoin without approval from the Coinowners. Analyzed in another way, based on R3A§2.02(1), Sam lacks authority because selling the Bitcoin is not "necessary or incidental" to the objectives of his agency, which are to "propose... what action Virco should take" and "execute on Virco's behalf any decisions that had more votes in favor than votes against". Therefore, Sam's tort was not within the scope of his actual authority, so Virco is not liable for it under R3A§7.04.

- (d) **Apparent authority:** Under R3A§7.08, a principal is vicariously liable "for a tort committed by an agent... when actions taken by the agent with apparent authority constitute the tort...". Since the sale of the Depositors' Bitcoin was a tort, Virco would be liable if Sam had apparent authority to sell it to Aurum.

Sam would have apparent authority to sell to Aurum the Bitcoin deposits on Virco's behalf if a manifestation by Virco, perceived by Aurum, made Aurum reasonably believe that Sam is authorized to sell the Bitcoin deposits on Virco's behalf (R3A§2.03). The manifestations were that Sam was Virco's Servant and the description of the Servant's authority in the Constitution. From that description it is clear that the Servant can make proposals to the Coinowners, but has no authority to act on Virco's behalf without Coinowner authorization. The facts state that Aurum didn't "know whether Sam received Coinowner approval for the Bitcoin sale. However, Aurum knows the agent they are interacting with needs to get authorization for their actions. If a reasonable third party in such a situation would inquire to confirm that the authorization was given, then the sale/conversion of the Bitcoin was not done with apparent authority. There would be apparent authority only if a third party could reasonably assume that Sam received prior authorization to sell the Bitcoin, which I think is not supported from the circumstances given to us.

Because Aurum knows that Sam was a partner and Virco was a general partnership, one may also deduce apparent authority from UPA §301(1), which states that a partnership is bound by an act of a partner to "apparently carry on in the ordinary course the partnership's business", unless the partner lacked actual authority and the third party knew or received notification that the partner lacked authority. Selling cryptocurrency is likely within "the ordinary course of the partnership's business for a FinTech/cryptocurrency company."<sup>2</sup> Sam lacked actual authority. And Aurum did not know that Sam lacked authority. However, Aurum probably "received notification" of Sam's lack of authority by being aware that the Constitution required each Servant act to be authorized by the Coinowners, and not having knowledge that an authorizing vote took place. Thus, the conclusion is again that the sale/conversion of Bitcoin was not done with apparent authority, and Virco is not liable under R3A§7.08.

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<sup>2</sup> Some students found it was not in the ordinary course of business because of the scale of the sale, which was very large for the partnership (all \$10M of its deposits). This is an acceptable argument.

- (e) **Respondeat Superior:** Virco would be liable under Respondeat Superior if Sam was its employee and the conversion of Bitcoin was done within his scope of employment.

Employee: Sam would be Virco's employee if he acts on Virco's behalf, and Virco "has the right to control the manner and means of the agent's performance of work" (R3A§7.07(3)(a)). The Constitution creates a mixed right to control. In general, there is extreme control of the agent's performance of work, since the Servant must get Coinowner approval for any action on Virco's behalf. On the other hand, the Servant has discretion on what to propose to the Coinowners for a vote, which suggests no control over how the Servant performs this task, and which limits the Coinowners' control to negative control (they can block actions they don't like, but they can't force actions they like). Under *Borello*, a principal is an employer if they have "all necessary control", even if they didn't have control over every aspect of the agent's behavior (including the aspects that were the instrumentalities that caused the harm). Here, Coinowners have the right to block every action on Virco's behalf (the only don't control the ability to propose actions). This suggests that they have "all necessary control" and Sam is Virco's employee.<sup>3</sup>

Scope of employment: The Bitcoin conversion was within scope of employment under the control test of R3A§7.07(2) because, while it was not assigned by Virco, it was "in a course of conduct subject to the employer's control", since all actions on Virco's behalf required Coinowner approval. Likewise, it was within scope of employment under the purpose test of R3A§7.07(2) because Sam sold the Bitcoin to Aurum to raise money for Virco so that it could buy Virtue coins and stop their fall in price (i.e., his purpose was to serve his employer).

Because the Bitcoin conversion was done by an employee within his scope of employment, the employer (Virco) is liable to the Depositors (the victims of the tort) under R3A§7.07.

- (f) **Ester's liability as a partner in Virco:** Ester is a partner because she owns Virtue coins, which cause her to share control and share profits in Virco, which is a general partnership (see 1a). General partners owe unlimited liability for the obligations of a general partnership (UPA§306(a)). Because Virco is liable to the Depositors for Sam's tort (under Respondeat Superior), and Ester is a partner in Virco, Ester has unlimited liability for the damages caused by the tort. This liability is joint and several, so the Depositors can hold Ester liable for the entire value of the deposits (i.e., the partnership's full tort obligation), not just for Ester's share in the partnership.

However, even though Ester is liable for the partnership's tort obligation, the Depositors would likely be unable to collect the judgement from Ester's personal assets because under UPA§307(d), a judgement creditor of a partner may not collect from a partner's personal assets a judgement owed based on the partner's unlimited liability, until certain conditions were met, including receiving a judgement against the partnership and demonstrating that the partnership's assets are insufficient to satisfy

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<sup>3</sup> Some students reached the opposite conclusion, that Sam was not an employee because of the Coinowners' lack of positive control (the ability to force actions they want, rather than just block actions they don't want). This was an acceptable argument.

the judgement (in other words, the partnership's creditor must collect from the partnership first). Since under our facts the Depositors have not sued Virco, they would not be able to collect (at this point) from Ester.

## **2. Virco v. Aurum:**

Since Virco conceded that Sam had apparent authority to sell the Bitcoin sale to Aurum, it must accept the sale as binding on it. However, if Virco can show that Sam breached his fiduciary duty to Virco when he sold the Bitcoin (on Virco's behalf) to Aurum, and also show that Aurum aided and abetted that breach, then Virco can collect from Aurum damages proximately caused by the breach.

- (a) **Duty:** Sam was Virco's agent, both because he was a partner in Virco (and as such an agent of Virco), and because he was an agent in his role as the Servant (See 1b). As an agent, Sam owes a fiduciary duty to Virco.
- (b) **Breach:** Negligence: The decision is of extreme importance (it involves most of the assets Virco controls and Virco is fighting for its survival), but Sam believes in good faith (and with some rational basis) that he must act within a few hours of it would be too late. This does not leave room to conduct lengthy searches and hire experts, and Sam has already spent some time informing himself by searching for other financing options (though he only searched for loans, not for sales of Bitcoin). Under these circumstances, a reasonable agent may have decided to act without authority and get ratification later, rather than fail to act in time. It's less clear whether a reasonable agent would do so when the act is not only unauthorized, but tortious (and perhaps criminal), but unlike the fiduciary duty of directors, fiduciary duty of agents does not have a "bad faith" category that makes all conscious illegality a breach of fiduciary duty. Sam was probably not negligent in his actions.

Self-dealing: Sam was self-dealing when selling the Bitcoin to Aurum, because he was on both sides of the transaction (owing a fiduciary duty to both sides), and thus served as an adverse party to Virco in violation of R3A§8.03. Virco's interest in selling an asset was to get the highest price possible. Sam had a conflicting fiduciary duty as a director in Aurum, and as the buyer Aurum's interest was to get the lowest price possible. The conflict was connected to Sam's fiduciary relationship to Virco because he was negotiating the transaction on Virco's behalf. Under Agency SoR, any agency self-dealing breaches fiduciary duty, regardless of the fairness of the behavior. Therefore, Sam breached his fiduciary duty to Virco.<sup>4</sup>

- (c) **Knowing participation:** Aurum didn't know that the Bitcoin did not belong to Virco, and that therefore selling it was a tort (and thus possibly negligent). Therefore, even if Sam breached FD for negligence, Aurum did not knowingly participate in that breach. However, Aurum was aware that Sam was an agent of Virco, and that he was a

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<sup>4</sup> Some students wrongly argued that Sam received a benefit out of fiduciary position, either because his actions boosted the value of Virtue coin that he owned, or because as Virco's founder his personal reputation would be harmed if he let Virco fail. These are not personal benefits because the benefit to Sam is derived from the benefit to Virco (i.e., to Virtue Coinowners). Some students pointed to a conflict between Sam's (and other Virtue Coinowners') interests and those of the Depositors. This conflict exists, but Sam does not owe his FD to the Depositors, but to Virco and thus to the interests of Virtue Coinholders.

director in Aurum. Therefore, Aurum knew that Sam was conflicted in the transaction, and nonetheless they participated in it.

- (d) **Damages proximately caused by breach:** This is a difficult element for Virco to prove. If the Bitcoin was sold below its fair value, the difference between the payment received and the fair value would be damages caused by the breach. The Bitcoin was valued at \$10M and sold for \$9M (so, \$1M in damages), but Sam believes this is the best price he could get in a “fire sale” (closing the sale right away rather than taking time to shop for the best price), so it’s possible that the fair value of the Bitcoin in a fire sale is \$9, in which case there are no damages.