University of Illinois College of Law
Examination Cover Sheet

Mergers & Acquisitions
Professor Amitai Aviram
Spring Semester 2016
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, RUPA, and U.S. securities law.
   b. Each corporation's charter states that: the corporation is a stock corporation, has limited liability and perpetual existence; the corporation may conduct any lawful act or activity; director fiduciary duty is limited to & director/agent right to indemnification is extended to the maximum degree allowed under DGCL §102(b)(7) ; the board may amend the bylaws.
   c. Each corporation's bylaws state that: the chairperson of the board is authorized to call a board meeting; and the board is authorized to call both annual & special shareholder meetings.
8. **"Fact" patterns are fiction**: The "facts" presented in this exam were constructed for an educational purpose, and are not intended to inform about any real person or event.

Sol Corporation ("Sol") was a publicly-traded Delaware corporation that developed, built and operated solar power plants. It signed long-term supply contracts with large commercial electricity users, and then build solar power plants to supply this electricity. This business model required Sol to make very significant upfront investments in building the power plant, after which Sol would have steady and predictable income from the long-term supply contracts.

Chandler, Sol's CEO, had developed early on a strategy that called for Sol to grow as quickly as possible, since he believed that there were significant economies of scale in this industry, and the largest solar power suppliers would be able to produce the cheapest electricity and outprice the competition.

Chandler quickly discovered that the main constraint that prevented Sol from growing faster was lack of funds to develop new solar power plants. Each plant was very expensive to build. Once it operated, it would earn a steady profit, but profits accumulated slowly and it would take many years before an existing plant would earn enough profits to fund the building of a new plant. Sol's competitors faced the same problem, and kept raising new funds by borrowing as much as they could and by issuing new shares, but it was difficult for risky start-up investments such as Sol and its rivals to raise enough funds to build many new plants. Thus, Sol (and its rivals) had to turn down profitable supply contracts because they could not raise enough money to finance construction of more plants.

Chandler found a solution to this growth constraint. Because interest rates were very low, investors were eager to replace bonds (that earned almost no interest) with shares in companies that earned a safe and predictable return and paid it out regularly as dividends. Unfortunately, Sol did not fit this company profile at all, since it was risky and used any profits it earned to develop new plants rather than to pay dividends. But each power plant project in itself fit the company profile these investors wanted: a predictable cash flow from the long-term supply contracts, low and predictable maintenance expenses, and thus the ability to pay stable and predictable dividends.

To tap those investors, Chandler made Sol create a Delaware subsidiary called YieldCo Inc. ("YieldCo"). YieldCo had two classes of shares: Class A shares had the right to 90% of YieldCo's economic rights (e.g., right to dividends) and to 40% of control rights (i.e., votes as shareholders). YieldCo's Class B shares had 10% of YieldCo's economic rights and 60% of control rights. Sol owned all Class B shares, and sold Class A shares to the public (Class A shares then traded on NASDAQ).

YieldCo's board of directors consisted of seven directors: Aaron, Bashir, Chandler, Daphne, Ella, Frank and Gabriella. Aaron was YieldCo's CEO, who was also Sol's Chief Financial Officer. Bashir was a partner in a venture capital firm that had a sizable investment in Sol. Daphne, Ella, Frank and Gabriella have no affiliation with Sol.

YieldCo used the money raised from selling Class A shares to buy from Sol power plant projects that Sol was just beginning to develop. YieldCo paid in advance, and Sol used the money to build the plant. When it finished building the plant, ownership of the plant was transferred to YieldCo, and Sol transferred to YieldCo the long-term electricity supply contracts. Sol would maintain the power plant in return for a monthly fee from YieldCo, and YieldCo would collect payments for the electricity from customers.

Thus, once the plant was completed, YieldCo would get a steady income for the electricity, subtract from it the fee paid to Sol for maintenance, subtract also a few administrative costs (such as the salaries of YieldCo executives), and then deliver all remaining profits to shareholders as dividends. Since both the income and the costs were stable and predictable, YieldCo's dividend was stable and predictable, making it a very appealing alternative to investing in bonds. Demand for YieldCo's shares was high, so it kept raising more and more money (by issuing more and more Class A shares to the public), and used the money to buy from Sol more and more projects.

Since all of YieldCo's transactions were with Sol, YieldCo's board formed a three-person Conflicts Committee ("the Committee") tasked with evaluating each deal that Sol proposed and negotiating with Sol those deals the committee believed were in YieldCo's interest. Daphne, Ella and Frank were appointed to the Committee. YieldCo's bylaws stated that the board could not approve a transaction with Sol that was not approved by the Committee.

YieldCo's success in raising money removed the growth constraint for Sol, which became the fastest growing alternative energy company. As Chandler had hoped, increase in scale of operations did seem to reduce costs, and Sol seemed to be on the verge of dominating its industry. However, the speed at which Sol was growing meant that it was running out of profitable long-term supply contracts. To find customers for the growing number of plants it was building (and selling to YieldCo), Sol had to agree to less profitable electricity prices from less reliable customers.

Meanwhile, the Fed raised interest rates, making YieldCo's dividend less attractive compared to bonds. YieldCo's stock price dropped, making it difficult for YieldCo to raise more money to buy more of Sol's projects.

Chandler, however, believed Sol had to continue to grow. To finance this growth, Sol borrowed $500M from a bank for one year, using Sol's shares in YieldCo as collateral. Chandler also hired advisors to consider strategic options to improve Sol's financial situation, including seeking parties interested in acquiring Sol.

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Nine months passed and Sol's $500M loan was to come due in three months. Sol had no money to repay it, so Chandler asked the bank to extend the loan for another year. The bank, concerned about Sol's declining financial situation, was only willing to lend $200M (and that, only for another three months), requiring Sol to pay back $300M. Sol sought to borrow from other sources to pay the bank, but no one was willing to lend.

Facing the risk of default (which would result in losing its shares in YieldCo to the bank), Sol offered to sell to YieldCo, for $300M, a project it was beginning to develop in Indiana ("the Project"). Chandler asked the Committee to consider this transaction.

The Committee studied the details of the Project, aided by advisors. It unanimously decided that buying the Project was not in the interest of YieldCo, and informed Chandler of its decision.

The next day, Sol (acting as a shareholder in YieldCo) executed a written consent that removed Daphne, Ella, Frank and Gabriella from the board, and appointed four other directors, David, Eli, Francesca and Gideon, to YieldCo's board. David, Eli, Francesca and Gideon are not affiliated with Sol.

Later that day, YieldCo's board met and appointed David, Eli and Francesca to the Committee. Chandler and Aaron asked the Committee to consider Sol's proposal for the Project, not mentioning to them that this proposal was considered and rejected by the previous Committee.

The Committee studied the proposal for several days, aided by advisors. It was concerned about the price and asked Chandler to lower it. Chandler replied that Sol had to get $300M for the Project, because that was the cost to Sol of developing the Project, and he said that money was going to be used exclusively to develop the project, and without the entire amount, the Project could not be completed. In fact, Chandler knew that the $300M would not be used to develop the Project, but rather to pay back the loan to the bank and avoid foreclosing on Sol's shares in YieldCo. He said what he did to prevent the Committee from using Sol's desperation to repay its loan as leverage in the negotiations, and because he thought the Committee was less likely to haggle on the price they paid for the Project if they thought Sol needed that amount to complete its construction.

The Committee decided unanimously to buy the Project for $300M, and YieldCo's board decided to call a special shareholder meeting to hold an advisory vote on whether to approve the deal. This was not required by law or by YieldCo's constitutional documents, but Aaron persuaded David, Eli, Francesca and Gideon that it couldn't hurt (the real motivation, for Aaron, Bashir and Chandler, was their discomfort with having the new Committee approve a deal that was just declined by the old Committee, but they did not mention that to David, Eli, Francesca and Gideon, nor did they mention this to the shareholders).

The shareholder special meeting was called properly, 85% of the shares participated, and 98% of them approved buying the Project. YieldCo transferred $300M to Sol, which paid the bank that sum. The bank extended the remaining $200M loan for three months, again using Sol's shares in YieldCo as collateral.

In YieldCo's next board meeting, Aaron inadvertently mentioned that Sol used the $300M to repay a loan (not to develop the Project). David was furious that the money was not used as Chandler said it would. In the ensuing conversation, David, Eli, Francesca and Gideon learned that their predecessors on the Committee had considered the Project and rejected it.

Someone leaked these events to the media, and they became public knowledge. Shari (a YieldCo shareholder) sued Sol, alleging that it breached its fiduciary duties to YieldCo and its shareholders.

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Meanwhile, Sol's financial situation has gone from bad to worse as unexpected losses made it unlikely it would be able to pay the $200M, three-month loan that was soon coming due. If Sol defaulted on this payment, the bank could foreclose Sol's shares in YieldCo.

At this point, Sol's advisors finally found a potential acquirer: Creative Coercion, Inc. ("CCI"), a private equity firm. CCI offered to acquire Sol for $2/share. Sol asked to negotiate for a higher price, and CCI agreed on the condition that Sol agreed to an exclusivity period in which it would not be allowed to negotiate with other bidders. While negotiating, another firm approached Sol with an offer of $4/share, but Sol could not negotiate with that bidder because of the exclusivity agreement. CCI raised its bid to $2.15/share. Sol's board decided to decline CCI's offer, is large part because the $4/share offer caused them to feel that they could get a better deal from someone else.

In response to Sol's rejection, CCI purchased from the bank the $200M loan to Sol that was soon coming due (so now Sol owed the $200M to CCI). Sol desperately sought to sell itself before the loan became due, but by this point, the bidder who had offered $4/share was no longer interested in Sol and no other bidders emerged. Sol therefore agreed to negotiate again with CCI (this time, without exclusivity). But now CCI was only willing to pay $1.75/share, below its original offer and even below the $1.80 price at which Sol shares were trading.

As Sol and CCI negotiated, the $200M loan came due and Sol could not pay. CCI gave a notice of default and began proceedings to foreclose on Sol's YieldCo shares. Facing the threat of losing those shares, Sol signed an agreement to sell itself to CCI for $1.75/share. The agreement gave Sol 30 days to shop for better offers, but if the agreement was terminated by Sol, it would need to pay CCI a termination fee equal to 7% of Sol's value. The agreement also stated that CCI would give Sol, immediately after signing the agreement, a one-year loan that CCI could convert at any time to Sol shares for $1/share (given that Sol's shares were trading well above that price, CCI would make a profit equal to 8% of Sol's value if it converted the loan into shares). Sol called a special shareholder meeting to approve the transaction.

After the 30-day shopping period ended (without a new bidder emerging) but before the shareholder vote, Sid (a Sol shareholder) sued to enjoin the sale of Sol to CCI, alleging that the board breached its fiduciary duties in agreeing to this sale. **Discuss Shari's suit and Sid's suit** (assume there is no challenge to plaintiff's standing in either case, so do not discuss issues related to standing).

Model answer for the Spring 2016 M&A exam

Shari's suit[1]

1. **Duty**: Sol owes YieldCo and its shareholders a FD "only if it owns a majority interest in or exercises control over the business affairs of the corporation" (*Ivanhoe*). Through owning Class B shares Sol has 60% of control rights (>50%), so it owes a FD when exercising control. Sol also demonstrated its control by replacing YieldCo's four independent directors.

2. **Flaws**: Self-dealing (deal between Sol & Sol-controlled YieldCo); fraud (saying $300M are needed to finance the project, when money was used to pay loan).

3. **SoR**: Under *MFW*,[2] entire fairness applies to a firm's transaction with a controller, unless the transaction was approved by:

a. Committee of independent directors: David, Eli and Francesca were independent and had independent advisors, but they likely cannot be considered informed when Sol deliberately hid from them that the prior Committee considered and rejected the Project, as well as misrepresenting the use of the $300M. Furthermore, it doesn't seem to be a "robust procedural protection" when controller replaces committees that make unappealing decisions until they get a committee that decides in a manner that pleases the controller. This undercuts the committee's bargaining power against the controller or its independence.

b. mSHs: Majority of all mSHs approved the transaction, but the approval was advisory (so not an unwaivable condition to the transaction) and mSHs were not informed (no disclosure that a prior Committee rejected the Project or that new Committee was misinformed that deal's proceeds would fund the Project – both of these are material in that they affect reasonable mSH's decision whether to approve the Project).

Because of these flaws, procedural protections aren't robust and entire fairness applies (otherwise, BJR would apply to the fraud allegation).

4. **Application – Entire fairness**: Court considers fair price and fair process.

a. Fair process: Process was deeply flawed. This in itself may render unfair even fairly-priced transactions (*Nine Systems*). Flaws included:

- Chandler telling the committee the $300M would be used to develop the Project, though he knew it would be used to repay Sol's debt. This amounts to fraud, as Committee may have pressed harder or declined the deal if it knew a lower payment would not affect the Project's success, that Sol may run out of money to develop the Project, and that YieldCo can leverage Sol's desperation to pay its debt. Intentionally providing misinformation may amount to fraud, which would

[1] Shari's suit is loosely based on: Liz Hoffman, *Inside the Fall of SunEdison, Once a Darling of the Clean-Energy World*, WSJ (April 15, 2016), p. A1.

[2] I am not sure why many exam answers applied *Kahn v. Lynch* rather than the newer *MFW* (perhaps relying on answers to old exams before *MFW* came out). It is still correct to cite *Kahn v. Lynch* to determine who has the BoP to prove fairness, but the preliminary question is what SoR applies, and *MFW* controls this issue, rather than the older *Kahn v. Lynch*.

breach FD even under the more lenient BJR, and surely would render the transaction unfair.

- Replacing a committee when it makes decisions undesirable to the controller and resubmitting the decision to a new committee, which amounts to rolling the dice repeatedly until they come out "right".
- Failing to inform the Committee and SHs about the previous Committee's rejection of the Project, which is clearly material information.
- Making the SH vote advisory.

b. Fair price: Court would consider expert testimony to determine if $300M was a fair price for the project. Since price was determined by a factor unrelated to Project's value (Sol's debt), it may be unfair.

<u>Sid's suit[3]</u>

1. **Duty**: Sol's board owes FD as directors.

2. **Flaws**: Corporate waste (transaction not in SHs' interests, though no self-dealing allegation).

3. **SoR**: Enhanced scrutiny applies under *Revlon*, because the court embarked on CoC transaction, selling control of Sol to CCI. Enhanced scrutiny also applies under *Blasius* & *Unocal*, because agreeing to the termination fee & convertible loan (together, "deal protections") – could coerce SHs to vote for the transaction (losing termination fee and diluted by loan conversion if they reject it).[4] The convertible loan is similar to a termination fee because it would be converted if CCI buys Sol, in which case the below-value conversion price transfers value from existing Sol SHs to CCI.[5]

4. **Application** (enhanced scrutiny)

a. Did the board find, in good faith & after a reasonable investigation, a legitimate purpose that warranted the board's act?

- Legitimate purpose: Since *Revlon* applies, the board must maximize short-term SH wealth by getting the best terms for the sale of Sol. As explained in 4b2, the board's behavior appear reasonably related to seeking the best sale terms.
- Good faith & reasonable investigation: The board is independent of CCI, even if CCI has significant leverage over the board in the threat to foreclose on the shares in YieldCo. No facts cast doubt on good faith and reasonable investigation.

b. Was the act a reasonable response proportionate to the purpose?

[3] Sid's suit is based on *In Re Comverge, Inc*., Not Reported in A.3d, 2014 WL 6686570 (Del.Ch. 11/25/14).

[4] Many students failed to apply *Blasius*/*Unocal*, not recognizing that deal protections were a takeover defense ("lock-ins", or contingent rights). The key to applying these cases is whether a board action interferes with shareholders' voting or share-selling rights, not whether a specific acquisition offer is being thwarted. It is possible for *Unocal* to apply when board action thwarts SHs' ability to sell to potential acquirers, even when a specific potential acquirer has not materialized – for example, a firm implementing a poison pill before anyone has made a bid to buy it will already trigger *Unocal*.

[5] It was important to explain why the convertible loan interferes with shareholder rights – in this case, why it affects voting against the deal. If the convertible loan had the same effect however SHs voted on CCI's offer, it would not be analyzed under enhanced scrutiny but under the BJR.

1. Under *Unitrin*, act is unreasonable if it's coercive or preclusive. Deal protections are not preclusive – firm may terminate the deal and sell itself to another firm if it pays the termination fee. However, termination would lead to a transfer of 15% of the firm's value from the shareholders to CCI (7% in cash payment, 8% in diluting existing Sol SHs). This is possibly high enough to be considered coercive – a reasonable SH might be forced to vote for the sale to CCI even if she thought it was a bad deal, just to avoid losing 15% of the firm's value.
2. Otherwise unreasonable – *Revlon*: Sol actively sought potential bidders for over a year through its adviser, but other than CCI only one bidder appeared, then withdrew. Also, the 30-day shopping opportunity, when it was public knowledge that Sol is for sale and is shopping for other offers, is similar to passive shopping that was deemed sufficient to satisfy *Revlon* duties in *C&J Energy*. Thus, the board appears to act reasonably find the best offer (*Unitrin*). The only flaw in the board's actions was agreeing to significant deal protections, which may have deterred bidders in the 30-day shopping window. This is analyzed next.
3. Otherwise unreasonable – *Unocal*: Deal protections worth 3% of deal's value were deemed reasonable, but the 7% termination fee is likely unreasonable, and coupled with the value transfer in the convertible loan it reaches 15% and is almost certainly unreasonable.