University of Illinois College of Law
Examination Cover Sheet

Mergers & Acquisitions
Professor Amitai Aviram
Spring Semester 2023
Number of Pages: 5 (including this page)
Exam Date & Time: Wednesday, May 3, 9am.

Exam Instructions

1. **Accessing and submitting the exam**
   a. The exam form will be e-mailed to you by my administrative assistant, on the Exam Date & Time.
   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 within 6 hours of the Exam Time (i.e., before 3pm)**, by e-mailing it as an attachment to my administrative assistant Kelly Downs (kdwns@illinois.edu).
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 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.
8. **"Fact" patterns are fiction**: The "facts" presented in this exam are not necessarily true in real life.

Cass and Claire were colleagues working as senior executives at a bank, before the quit to start their own bank. They founded Prosperous Valley Bank ("PVB"), a closely-held Delaware corporation that offered banking services to the communities of Prosperous Valley.

PVB had a single class of stock. To satisfy regulatory requirements, PVB raised equity capital from investors (money raised from selling shares). After raising this money, Cass and Claire each owned 26% of PVB's stock. PVB's board was composed of 5 directors: Cass, Claire, and three independent directors who had no financial or personal connection to Cass or Claire. One of these three independent directors chaired the board.

PVB's business model was simple: raise money by holding customer deposits in checking and savings accounts (for which the bank pays a low interest rate), and use these funds to lend to Prosperous Valley businesses and offer mortgages to Prosperous Valley residents (at a higher interest rate). The difference between the deposit and loan interest rates was the source of PVB's profit.

PVB's founding came at a fortuitous time. A few years earlier, Prosperous Valley University had received a large alumni donation to open a new engineering program. Since it was building the program from scratch, it had no "legacy" faculty who focused on now obsolete sectors of the industry, so it hired faculty with expertise in some of the hottest tech areas, such as Artificial Intelligence and cutting edge Biotech. Then came the Covid epidemic, and for many of the program's early graduates it was appealing to stay in rural and inexpensive Prosperous Valley rather than move to more crowded large cities. These graduates formed start-ups in Prosperous Valley, and they became core customers of PVB, both keeping deposits with, and taking loans from, the bank.

PVB had several highly profitable years, but all good things come to an end. International tensions resulted in less international trade, which soured the outlook for many of Prosperous Valley's start-ups. As they scaled down their operations, they needed fewer loans. PVB now had more money from its deposits than it had demand for lending that money. To get some return on that money PVB lent it to the government by buying U.S. Treasury bonds (the "Bonds"). PVB bought 10-year government bonds, which offered higher interest rates than shorter-term bonds.

The economic outlook continued to get gloomier. Further reduction in international trade and big government budget deficits caused inflation to rise. In response, the central bank raised interest rates significantly. Because interest rates rose, PVB had to raise the interest rates it paid on deposits, or else depositors would move their deposits to rival banks. However, PVB was stuck for 10 years with the low interest rates on the Bonds, so now it was paying more interest on the deposits than it was receiving on the government bonds, which meant that it was slowly losing money. This was bad, but not catastrophic: the rate of loss was slow, and PVB's board was hopeful that within a year or two interest rates would go back down, and it could pay less interest on deposits and return to profit.

Then things got worse. Despite raising interest rates on deposits, rival banks (who did not have their money stuck in low-interest loans or bonds) were offering higher interest rates, and customers gradually pulled their deposits out of PVB. PVB's treasurer estimated that at current trends, PVB would run out of cash in 3 months.

The board hired bankers from Goldman Sachs ("GS"), a prominent investment bank, as advisors to figure out how to raise enough cash to survive until (hopefully) interest rates went back up. GS did a thorough investigation of PVB's finances and reported to the board. The Bonds amounted to 90% of PVB's assets, so the most obvious option was to sell some of them. This would both raise cash and reduce the amount of funds trapped in low-interest bonds. But there was a catch: because the bonds paid a lower interest rate than the current rate, their price had dropped by about 20% from what PVB paid when it bought them (basically, the drop in price represents the small rise in interest rates, times the 10 years of the bond's duration, which adds up to a large amount).

As long as the bank held the Bonds, it only needed to record as losses the small difference between the interest it paid on deposits and the interest it collected on the bonds. And if interest rates went back down in a few months, those losses would stop. But if PVB sold the Bonds, it would need to record as a loss the 20% drop in Bond prices (which represents, all at once, 10 years of the bank's current rate of loss). That would wipe out PVB's equity (an accounting figure representing the money the shareholders paid for their shares, plus profits that accumulated in the good years). Once it was known to the public that PVB's equity was low or even negative, it would trigger a bank run as customers withdrew their deposits out of fear that the bank would become insolvent, and the withdrawals would turn the fear of insolvency into a self-fulfilling prophecy.

The alternative was for PVB to issue new shares, but given PVB's challenges, share prices would be very low, so many shares would need to be sold and that would significantly dilute existing shareholders' share of the company.

The board asked GS to simultaneously search for buyers for the Bonds and for buyers for newly issued shares, and to present specific possible deals at next week's board meeting. Unfortunately for PVB, during that week there was additional international turmoil that caused the Fed to raise interest rates again. Higher interest rates caused a "triple whammy": PVB's customers withdrew more of their deposits to deal with worsening conditions in their own businesses, lowering PVB's cash reserves; higher interest rates also increased PVB's loss rate (the difference between what it paid on deposits and what it received on the Bonds); and the market value of the Bonds dropped further, now down 50% from the price at which PVB bought them.

At the next board meeting, GS reported that the option of raising money by selling stock was now off the table: investors who initially showed interest had withdrawn, spooked by the worsening market conditions. Furthermore, the triple whammy of effects meant that PVB had to sell at least 40% of the Bonds just to have enough cash for the next 3 months. There would be no problem finding buyers for the Bonds, but at current prices selling that many bonds would require recording a loss that would wipe out PVB's equity entirely.

This would almost certainly cause a bank run. In conclusion, GS advised PVB to hire bankruptcy experts in anticipation of insolvency.

Cass and Claire asked GS to stay for a private chat after that dramatic board meeting. In that chat, Cass and Claire wanted to check with GS the viability of a deal in which they would offer PVB a lifeline. They signed an agreement with GS (the "CCGS Agreement") under which GS would devise a deal to rescue PVB (the "Repurchase"). In compensation for GS's work in devising the Repurchase, the CCGS stated that Cass and Claire would pay GS a "success fee" (equal to the amount GS was paid for its work for PVB) if the Repurchase took place, but Cass and Clair would not need to pay GS anything if the Repurchase didn't take place (e.g., if PVB rejected it).

The Repurchase, which GS devised, consisted of two connected transactions. First, Cass and Claire (the "Buyers") would buy all of the Bonds from PVB at the price PVB originally paid for them (the "Purchase Price", which was double the current price, since the bonds were down by 50%). This meant that PVB would not take any loss to its equity; the Repurchase would provide PVB with enough cash to operate for the foreseeable future; and it would also eliminate the source of the bank's losses, since the bank's assets would now be in cash that can be invested at the current, higher interest rates. The second transaction in the Repurchase was a contractual obligation by PVB to buy back the Bonds, in small portions, over time. Specifically, each month PVB was obligated to repurchase (from the Buyers) Bonds in an amount equal to PVB's profits that month (if it did not have profits that month, it did not need to buy back Bonds that month). The price at which the Bonds were repurchased was the Purchase Price, plus 15% of the Purchase Price times the number of years from signing the Repurchase agreement until each repurchase (in other words, equivalent to 15% "interest" on the Purchase Price). PVB's obligation would end when all the Bonds were repurchased from the Buyers.

In form, the Repurchase consisted of two agreements, one for the Buyers to purchase the Bonds from PVB, and the other for PVB to repurchase the Bonds from the Buyers. In substance, the Repurchase would be equivalent to a loan at 15% interest from the Buyers to PVB, of an amount equal to the Purchase Price, secured by the Bonds and by PVB's future profits, but (unlike a typical loan) the Buyers would not have recourse to any other assets PVB has.

An emergency meeting of PVB's board was properly called, in which Cass, Claire and GS presented the Repurchase. They told the independent directors that Cass and Claire hired GS to develop the Repurchase, but they did not mention the details of how they were compensating GS because they did not think that was relevant for the board.

Cass and Claire said that since they are the proposed Buyers, they are recusing themselves from any PVB board decisions regarding raising cash, and they left the meeting so as not to bias the board's discussion of the Repurchase. The remaining directors then grilled GS on the details of the Repurchase. When they asked on what basis the proposal set an "interest rate" of 15%, GS said that figure was what Cass and

Claire demanded, and while it was a high rate, in GS's view it was fair given that this was a risky deal for the Buyers, since the "collateral" (the Bonds) was currently worth only 50% of the amount of the "loan" (the Purchase Price), and the Buyer's ability to recoup anything beyond that depended on PVB earning sufficient profits in the future to repurchase the Bonds. GS also said that they tried their best to get anyone else to offer a similar deal at a lower rate, or a straightforward loan to PVB at a lower rate, and could not find anyone willing to do so.

The three independent directors dismissed GS and discussed what to do. They agreed that they had to make a decision at that very meeting, as any additional bad news could result in a bank run and bankruptcy. After thorough deliberation, they decided unanimously to accept the Repurchase.

Meanwhile, Cass and Claire sent the board a written notice stating that they approved the Repurchase. In the cover letter to which the notice was attached they explained that this notice was not in any way intended to sway the board's decision, but merely provided just in case their consent was needed for some legal technicality. The Chair of the board thanked them, but in her mind she thought that the notice was unnecessary, since the independent directors were sufficient to constitute a quorum for the board meeting, and in any case Cass and Claire were present at the beginning of the board meeting, so they would have counted for the board's quorum even after they left the meeting.

The next day, PVB signed the Repurchase agreement with Cass and Claire. PVB publicly announced the Repurchase. Customers and some shareholders cheered the deal, which overnight turned the bank from constantly losing money and on the brink of insolvency, to making a small profit and holding plenty of cash. But other shareholders were upset that the deal meant that all profits would go to Cass and Claire until the Bonds were fully repurchased, and also felt that 15% was too high. One such shareholder, Sven, sued Cass, Claire and the three independent directors, challenging the Repurchase agreement between PVB, Cass and Claire.

Discuss Sven's suit. Defendants did not challenge Sven's standing for his suit (so, do not discuss the standing issue).

Model answer for the Spring 2023 M&A exam

1. Lack of authority for an asset sale:

(a) The Repurchase would require SH approval if it amounted to selling "substantially all" of PVB's assets (DGCL §171). 90% of PVB's assets may count as "substantially all". But the substance of the Repurchase deal (combination of the purchase and repurchase transactions) is a loan secured by the Bonds, which doesn't require a SH vote. However, looking at the formal way the Repurchase is structured, the Bonds are sold, and thus a SH vote is likely required.

(b) A SH meeting was not called, but the notice from Cass and Claire may be seen as a written SH consent. Under DGCL §228, a valid written consent requires the support of enough shares that, if the same matter was voted on at a meeting in which all voting power is present, the support of those shares would be sufficient for that matter to pass. DGCL §171 requires support of a majority of the shares entitled to vote, which means >50% of total voting power. Cass & Claire jointly have 52%, so the asset sale was approved by SHs.

2. Board FD breach:

(a) Duty: The independent directors who entered into the Repurchase on PVB's behalf owe FD as directors.

(b) SoR: No self-dealing, since the three independent directors "had no financial or personal connection to Cass or Claire".[1] The board didn't deploy corporate power against shareholders,[2] but if the Repurchase is a sale of substantially all of PVB's assets (per its formal structure), then Enhanced Scrutiny is triggered under *Revlon* because PVB "embarked on a transfer of control" (selling substantially all of its assets

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[1] Some students found the three independent directors constructively conflicted because Cass and Claire failed to disclose GS's "success fee". Technically, this is correct: this information is material and Cass & Claire failed their duty to disclose it. However, this isn't the best analysis of the issue in point, which is the liability of the three independent directors. Constructive conflict does not impose liability on the constructively conflicted directors (the "victims" of the failure to disclose). Rather, it taints their votes with the self-dealing of the directly conflicted person who violated their duty of disclosure (potentially resulting in the invalidation of a decision supported by the tainted votes), so that a directly conflicted person can never benefit from failing to disclose. The constructive conflict would be relevant in a suit against Cass and Claire, if the latter argued they were not liable because the board's vote to enter the Repurchase ratified/authorized their behavior. Constructive conflict could also invalidate the board decision to enter the Repurchase (which could be the basis for an injunction if the Repurchase did not yet close), but would not in itself make any party liable for damages. Because constructive conflict can't impose liability on the three independent directors (or anyone else), it's not the best answer here, though it's not a wrong answer.

[2] Some students wrongly argued that *Blasius* applies because the directors did not bring the Agreement to a SH vote. If they referred to SH approval required under DGCL §171, the SHs did approve (only Cass and Clair, through a SH consent, but the consent was valid – see 1b). And if they referred to mSH approval that is part of the "robust procedural protections" – such a vote is not a right that SHs have (and thus failing to do it is not a *Blasius* violation). Rather, having mSH approval is a factor that affects the SoR for a controller FD claim (see 3b), and could raise a *Corwin* ratification defense for a board FD claim (see 2e). Also, some students wrongly argued that *Unocal* applies because the Repurchase diverted future profits to the Buyers, making it less likely anyone would want to buy PVB shares (and thus hindering SHs' ability to sell shares). But any transaction may result in costs or losses that reduce the desirability of the firm's shares. The Repurchase was neither intended to deter buyers of PVB shares, nor had that effect. The diversion of future profits was no different from taking a loan, knowing that future profits would need to be used to pay it back.

for cash) – See 2c.[3] Conversely, if the Repurchase is a collateralized loan (per its substance), then BJR applies – See 2d.

(c) Application – Enhanced Scrutiny:
- The Repurchase was not illegal, nor was it corporate waste, as it raised cash PVB needed and couldn't otherwise get.
- The board acted in good faith (directors who made the decision weren't self-dealing).
- The board conducted a reasonable investigation ("thorough deliberation", "grilling" the adviser, and time crunch requiring immediate action).[4] The directors didn't have an independent assessment of the fairness of the "interest rate", because GS had an incentive to say it was fair to proceed with the deal and double their compensation. However, the board did not know of GS's conflict, so they could rely in good faith on the fairness assessment of their advisor (DGCL §141(e)).
- Reasonableness: An action is unreasonable if it's coercive, preclusive, or otherwise unreasonable (*Unitrin*). The Repurchase agreement doesn't coerce SHs' vote (asset sales don't require a SH vote). It's not preclusive because it doesn't preclude anyone from acquiring PVB (the Repurchase has a similar effect to PVB taking a loan secured by a majority of its assets). No facts suggest it's otherwise unreasonable. No breach.

(d) Application – BJR: Essentially the same as the first three elements of 2c. No breach.

(e) If there was a breach, then informed, uncoerced SH approval ratifies directors' FD breach (*Corwin*). Here, SH written consent doesn't ratify since participating SHs were conflicted as PVB's counterparties to the Repurchase.

<u>3. Controller FD breach</u>:

(a) Duty: Cass and Claire individually aren't controllers, since each only owns 26% and has control of only 20% of board votes. But their holdings count joints as a control group if they are "connected in some legally meaningful way" (*Frank*), and possibly that connection may need to be related to the challenged transaction (*Patel*). Here, Cass and Claire jointly buy Bonds in the Repurchase, which is the challenged transaction (satisfying *Frank* & *Patel*). Together with being the co-founders, similar facts established a control group in *Tilray*. Thus, they are a control group that jointly owns 52% of PVB. As this is over 50%, they are presumed to be controller (*Ivanhoe*). Controller FD applies under *MFW* because Cass & Claire are on both sides of the transaction: they are the Bonds' buyers, and the controllers of PVB, which is the Bonds' seller.

(b) SoR: BJR applies only if "robust procedural protections" were in place. The deal was negotiated and approved by a board that was independent (Cass and Claire were not

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[3] Some students wrongly argued that *Revlon* did not apply because there was no change of control in PVB. But the transaction that triggers *Revlon* is the asset sale ("substantially all" of PVB's assets). Before the execution of the Repurchase, these assets were owned by PVB itself. After it, they were owned by Cass and Claire – thus a change of control.

[4] Some students wrongly argued that the fact that the board had to act immediately to avoid a bank run indicated insufficient investigation (because there was no time for a sufficient investigation). But the sufficiency of a board's investigation (obtaining information & analyzing it) is a function of how much time the board has. Thus, the time crunch had the opposite effect, of lowering the threshold for a sufficient investigation.

involved), satisfied its DoC (held "thorough deliberations" under time pressure), was authorized to select independent advisors (GS, which is "a prominent investment bank"), and had the board's full bargaining power and discretion because it was the board and not just a committee.[5] However, GS wasn't an independent advisor: it would earn a "success fee" (which was material, because it doubled the fee compared to just what PVB paid) only if the board approved the Repurchase.

The transaction was approved by a majority of SHs in a written consent, but all supporters were controllers; no mSHs approved the deal (nor was the Repurchase conditioned on such approval). Entire Fairness applies unless both independent board/committee approval and mSH approval were unflawed (*MFW*). Here, neither was, so Entire Fairness applies. Furthermore, both procedural protections were flawed, so unlike in *Lynch*, burden of proof regarding fairness remains on defendants.

(c) Application: Under *Weinberger*, the court examines fair process & fair price. While the controllers recused themselves from involvement on the board, they didn't disclose GS's compensation structure, which biased GS and rendered it conflicted on advising on the fairness of the transaction. The process also didn't include mSH voting on the deal. As for fair price (terms), GS "tried its best" to get a better or alternative deal and could not find one, suggesting this was the best deal available. GS, as expert in financial deals, also deemed the 15% "interest rate" fair. However, GS is conflicted by its interest in earning the "success fee", tainting its efforts and assessment. Since both process and price are flawed (due to avoidable choices), the Repurchase it likely unfair. Sven wins on the controller claim.

[5] Some students claimed that Cass and Claire rather than the independent directors negotiated the Repurchase, but that misunderstands their role. Cass and Claire negotiated (though their requirements conveyed to GS) on the Buyer side of the transaction; they did not negotiate on PVB's (seller's) side. The independent directors, negotiating with GS, could have asked for changes in the terms, and only they represented PVB on this transaction (not Cass & Clair). One could find a flaw in the board's failure to haggle (which may be what was meant in saying that the board did not negotiate), but the fear of a coming bank run seemed to justify avoiding the delay that would be caused by haggling.