

University of Illinois College of Law Examination Cover Sheet

Business Associations 2

Professor Amitai Aviram

Spring Semester 2010

Number of Pages: 5 (including this page)

Time Allotted: Until 10am on the day following the day you received the exam

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:** You must personally pick up a copy of the exam from Tina Lamb (Room 324) between 9-10am on the day of your choice among the following: May 5, 6, 7, or 10. You must submit the exam, by e-mail to Tina Lamb (tinalamb@law.illinois.edu), no later than 10am on the day following the day you received the exam.
4. **Confidentiality**
 - a. Once you receive this exam form, you are not allowed to discuss the exam with anyone until after the final day of the exam period for this semester (which may be later than the day of the exam).
 - b. Students who are enrolled in this course are not allowed to solicit or receive information on the exam if the source of this information (directly or indirectly) is a person who has seen the exam.
 - c. After the last day of the exam period for this semester, you are allowed to freely discuss the exam.
5. **Writing the exam**
 - a. The exam contains two questions. Answer one of them. I will grade only the question you answered first.
 - b. Unless the exam question specifies otherwise, assume that the relevant jurisdiction applies Delaware law.
 - c. Cite relevant case and statutory authority.
 - d. Within the constraints of 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.
6. **Length limit:** If you answer question 1 –
 - a. The total length of your answer should not exceed 1,000 words.
 - b. **For every 10 words in excess of the length limit (rounded up), one point will be taken off the exam's raw score.**
 - c. This section does not apply to students answering question 2.
7. **“Fact” patterns are fiction:** The “facts” presented in this exam were constructed for an educational purpose, and are not intended to refer to or inform about any real person or event.

Question 1

Radical Tastes, Inc. (“RTI”) is a publicly-traded Delaware corporation that produces unusually flavored foods. This is a risky operation, as many products flop, but the few that succeed tend to be very profitable. RTI has two classes of shares, with each class having 1 million shares authorized. The Certificate of Incorporation states that Class A shares each have one vote per share and one portion of the economic rights; and that Class B shares will have voting and economic rights as specified in a resolution of the BoD. RTI has issued 1 million class A shares to the public, and has yet to issue any Class B shares or even define their voting and economic rights. Rachel owns 300,000 A shares and is by far the largest shareholder. Rachel is the CEO of RTI, and is one of its three directors. The other two directors are Alan, the CEO of a public relations firm, and Ben, an experienced food engineer. Neither Alan nor Ben have any familial, social or financial connection to Rachel (other than serving together on RTI’s board and generally being on friendly terms).

Vampire’s Nightmare: The years 2005-2007 have brought a string of disappointments for RTI. A dozen different projects faltered and had to be discontinued. The company was still profitable thanks to significant but slowly declining revenues from past successes. However, the poor growth prospects depressed RTI’s share price. In response, Rachel decided to focus all of RTI’s marketing and development resources on a single, promising product – Vampire’s Nightmare (“VN”), a garlic-flavored ice cream. All other product development was discontinued to make resources available for VN.

VN turned out to be a nightmare, though not for vampires. After spending millions on promotion, sales were dismal. Rachel had RTI hire Alan’s PR firm to investigate why VN failed (Alan was not involved in negotiating the contract or in working on this project). After thorough investigation, the firm presented its report, in which it found two reasons for VN’s poor performance. First, VN was launched just as the US entered a recession, and consumers started to eat more at home and less outside. VN was only sold to ice cream parlors, not to supermarkets. Second, VN was launched just as several vampire books and movies became fashionable among teens and young adults. The report suggested that due to the growing popularity of vampires, teens and young adults did not like garlic-flavored ice-cream as much as RTI expected they would.

Dissent: VN’s flop caused RTI to post a small loss for 2008 – its first loss ever. In the annual shareholder meeting, Rachel explained the conclusions of the report, and said that RTI will not give up on VN, but rather will market it in a smarter way. Rebecca, a businesswoman who owned 5,000 shares, spoke and argued that VN failed not because of the recession or because of vampire fiction, but because nobody likes garlic-flavored ice cream. She called on RTI’s board to “put this corporate nightmare behind us” and to embrace another product that Rebecca thought was promising – Hot Stuff (“HS”), Jalapeño-flavored jarred baby food.

Following the shareholder meeting, Rebecca asked to meet with the BoD to discuss her plans for HS. Rachel promptly arranged for the BoD to meet with Rebecca that same week. However, it became clear during the meeting that all three directors thought HS was not promising, and that the BoD would not spend time and money exploring the idea.

Rebellion: Rebecca decided to take matters in her own hands. She formed Our Long Corporate Nightmare Is Over, Inc. (“OLCNIO”), a Delaware corporation. OLCNIO had one class of shares, with 10M authorized shares. Rebecca caused OLCNIO to issue all 10M shares and offer them to the public at \$10/share. In the prospectus given to investors, Rebecca explained that after OLCNIO raised money by selling shares, it would borrow up to ten times as much money from a bank, and use the money to acquire RTI. It would then replace RTI’s BoD and appoint Rebecca as RTI’s CEO. She would make RTI discontinue VN and develop HS. Once HS proved to be a success, OLCNIO would sell RTI’s shares (presumably, at a profit), and dissolve itself, distributing the money back to the investors.

The public offering was successful and OLCNIO raised \$100M. Other than the money it raised, OLCNIO had no assets. OLCNIO’s newly elected BoD hired Rebecca as CEO. Other than Rebecca (who could, under the employment contract, resign or be fired without cause at any time), OLCNIO had no employees.

OLCNIO wrote a letter to RTI’s BoD, offering to buy the company for \$750M, which was a 50% premium above the price of RTI shares that day. It also repeated its intention, once it acquired RTI, to discontinue VN and develop HS. Finally, the letter warned that if this offer was rejected, OLCNIO would “take the battle to RTI’s shareholders”.

Battle plans: The letter caught RTI’s BoD off guard. Alan had to fly to an important series of meetings for his PR firm that afternoon, and Ben was leaving the next morning on a family vacation which, he promised his wife, would not be cancelled for any reason.

Nonetheless, the BoD met immediately that morning to discuss the letter. The directors were unanimous that the price offered was far below RTI’s value, based on Rachel’s assessment that once VN sales reached their potential, RTI would be worth about \$1.5B. The directors also agreed that OLCNIO’s plan to discontinue VN and develop HS was bad. For two hours the directors discussed what they could do, and finally the board unanimously authorized Rachel to do the following things on behalf of RTI:

- (a) Write back to OLCNIO, rejecting their offer and stating that \$750M was far below the value of the company, as will become evident once VN proves a success.
- (b) Make a tender offer for OLCNIO’s shares, offering \$15/share (cost: \$150M).
- (c) Address the two issues raised by the PR firm’s report: (i) instruct the production department to produce a variety of garlic ice cream products that would be sold in supermarkets for people to eat at home (cost: \$100M); (ii) finance a big-budget movie aimed at teens and young adults, which portrays vampires as evil and garlic-flavored ice cream as potent protection against vampires (cost: \$250M).
- (d) Since RTI didn’t have \$500M available for the tender offer, product changes and movie production, the BoD authorized Rachel to have RTI borrow \$500M from a bank.

Rachel sent the letter, announced the tender offer, instructed the production department about the product changes, and began negotiations to borrow \$500M and to sign deals to produce the movie. Rebecca sued RTI’s directors derivatively, petitioning to enjoin the tender offer and the production of the movie.

Spare a dime?: Meanwhile, it became clear to Rachel that no bank would lend RTI \$500M in its current situation. If, however, RTI raised \$250M in equity (by issuing and selling new shares), then several banks were willing to lend the remaining \$250M. To raise \$250M at the current share price, RTI would have to issue 500,000 new shares. This raised two problems. First, all authorized Class A shares were already issued. Second, if 500,000 new shares were issued, Rachel's voting rights in the company would be diluted from the current 30% to 20%, making it easier for someone else to seize control of RTI.

She convened RTI's BoD (once Alan and Ben returned from their travels) to inform them about these problems. They agreed that calling a SH meeting to increase the authorized Class A shares would take a lot of time and cost a lot of money, so instead the BoD passed a resolution defining the voting and control rights of Class B shares to be identical to those of Class A shares, and instructed Rachel find buyers for 500,000 Class B shares.

As for Rachel's second concern (that her stake in the company would be diluted), Alan and Ben said that this was Rachel's problem, not RTI's. Indeed, Alan said, she would need to get BoD approval to issue the shares once she found buyers, and the BoD would not allow her to issue the shares in a way that entrenched her control at RTI's expense.

A girl scout CEO...: Rachel spent a lot of time fostering interest in RTI's shares, and managed to get several investors to bid. The highest bid came from Sarah, a well known corporate activist. Selling the shares to Sarah would result in Sarah becoming the largest shareholder in RTI, but Sarah was offering \$300M for the shares – much more than any other bidder – if she was allowed to acquire all 500,000 Class B shares that were up for sale. Rachel felt obligated to bring Sarah's offer to the BoD for approval, and the BoD approved, commanding Rachel for putting RTI's interests ahead of her own interests as the current majority shareholder. With \$300M raised, Rachel had no problem getting a bank to lend \$200M to RTI on good terms.

... But a shrewd shareholder: Rachel, of course, did not want to lose control of RTI. Therefore, she formed a Delaware corporation called Radical Holdings, Inc. ("Holdings"). Holdings issued Rachel 1 share in return for \$5M. Holdings then made a tender offer for all of RTI's Class A shares (but only the Class A shares), offering 1 share of Holdings in return for each share of RTI. Since RTI shares were trading for \$500/share while Holdings' single share was worth \$5M, most RTI Class A shareholders happily traded their shares for shares in Holdings (essentially, the \$5M that Rachel initially invested in Holdings served as a "prize" to be shared among all RTI shareholders who tendered their shares to Holdings). 800,000 of RTI's class A shares (including all of Rachel's 300,000 RTI shares) were tendered to Holdings. Rachel now owned 300,001 of Holdings' 800,001 shares, and was by far the largest shareholder in Holdings. Meanwhile, Holdings had 800,000 votes in RTI out of a total of 1.5 million votes (1 million Class A and 500,000 Class B), giving Holdings control of RTI.

Sarah, furious that control of RTI was snatched away from her, sued Rachel derivatively for breach of fiduciary duties.

Discuss: (1) Rebecca's suit; and (2) Sarah's suit. If demand futility is relevant to your analysis, you may assume that Rachel conceded that demand on RTI's board was not required (so you do not need to discuss demand futility).

Question 2

Note: The effective date for this question is **April 20, 2010**. In answering this question, please disregard any real world information that came out after the effective date.

From: Wendy I. Zeller [mailto:Ms.WIZ@work.com]

Sent: Tuesday, April 20, 2010 10:45 PM

To: Ms. WIZ Mailing List

Subject: CONFIDENTIAL – Project Bookworm

You've been assigned to work with me on Project Bookworm. One of our biggest clients, Charles Montgomery Burns ("Burns"), has again retained us to facilitate a transaction. Burns is the wealthy owner of the Springfield Nuclear Power Plant and a frequent participant in the popular television show The Simpsons. He is interested in acquiring control of Barnes & Noble College Booksellers, Inc. ("BNC"), a company recently acquired by Barnes & Noble, Inc. (NYSE: BKS) ("BKS") from one of BKS's SHs, Leonard Riggio. There's a major hurdle: BKS has no interest in selling BNC.

This just means it won't be a friendly deal (much to Burns' delight). We should explore two ways to facilitate this acquisition:

First, Burns could try to replace BKS's BoD with a slate of our candidates, without buying BKS shares (currently Burns does not own any BKS shares or any other BKS securities). Once appointed, BKS will negotiate with Burns to sell BNC to him at a mutually agreeable price.

Second, Burns could try to acquire enough shares to control BKS and then appoint his slate of BoD candidates. BKS will then negotiate with Burns a break-up of BKS, under which Burns would get 100% ownership of BNC in return for his shares in BKS. If there is a discrepancy between the value of BNC and the value of Burns' shares in BKS, one party will make a cash payment to the other to cover this discrepancy. Don't spend any time analyzing the future break-up deal – at this point we just need to figure out how Burns can acquire a controlling stake in BKS and what are the hurdles to such an acquisition. Burns has the cash to buy as much as 50.1% of BKS without having to borrow money. Thus far Burns has contacted one large BKS shareholder, Ronald Burkle, who has indicated willingness to sell his shares to Burns.

I need you to write a memo to Burns recommending how to acquire BNC. Make sure you fully analyze the two alternatives I mentioned above, though you may also discuss other ways for Burns to acquire BNC (or at least improve his leverage in inducing that acquisition) if you think of any.

If you looked at past exams you may have noticed that this law firm has a tradition of letting associates write important memos to clients while partners shirk. I have every intention to continue this proud tradition, so please do a good job – my reputation is at stake!

Thanks and good luck!

Business Associations 2 – Spring 2010

Answer to Question 1

1. Rebecca's suit

(a) **Claims derivative?** Yes. Applying *Tooley*:

- (i) Who suffers alleged harm? Here, the corporation, by overpaying for OLCNIO shares and by spending on a movie designed to support a product doomed to failure (VN);
- (ii) Who receives benefit of remedy? Here, requested remedy is an injunction against directors; since tender offer & movie cost corporate funds, enjoining them would add money to corporation's treasury.

Also, applying *Agostino*, plaintiff must show injury to corporation to prevail, since corporation (rather than SHs) would pay for the allegedly wasteful expenditures.

(b) **BJR or Unocal?** Movie production is primarily a business decision, so BJR applies. Tender offer is a Pacman takeover defense, so it's subject to *Unocal* enhanced analysis:

- (i) Did BoD act in good faith & after a reasonable investigation? Good faith, but possibly not reasonable investigation (see (c) below). No reliance on legal & financial advisers, so no *prima facie* proof.
- (ii) Reasonable response proportionate to threat posed? Under *Unitrin*: Not coercive – RTI SHs not manipulated by OLCNIO tender offer. Not preclusive – other bidders for RTI may appear even if OLCNIO is acquired by RTI (indeed, Greenmail encourages them to appear), though it does preclude OLCNIO making a bid for RTI. Even if not coercive or preclusive, is a \$50M loss (10% of RTI's valuation) proportionate to the risk to RTI's long-term plans in face of a (so far) non-coercive acquisition attempt? Probably not.
- (iii) *Revlon*: *Revlon* duties apply only when company embarks on transaction that will result in a change of control (*Lyondell*) – here, RTI is "just saying no", so no *Revlon* duties.¹

(c) BJR analysis

(i) Self-dealing: Directors aren't self-dealing. They strongly believe VN will succeed, but don't have a personal interest in VN different from SHs' interest.²

(ii) Reasonable investigation

- a. Necessary expertise & information: For tender offer, evidence that OLCNIO presents threat to SHs; evidence that cost of tender offer is proportional to threat posed (and as low as possible); for movie, evidence of expected cost & expected benefit from movie.

¹ A clever argument to the contrary (i.e., that *Revlon* applies) is that in selling 500,000 shares to Sarah, RTI entered a change of control transaction (since control shifted from Rachel to Sarah).

² To the extent that the actions are takeover defenses and one may suspect the directors have an entrenchment motive, the *Unocal* standard addresses that, and therefore entrenchment should not be "double counted" by considering it again under CoI/good faith.

- b. Importance: significant – \$400M expenditure for a company currently valued at \$500M, lacking cash and unable to borrow it.
- c. Did BoD acquire necessary expertise & information?
 - (1) Directors: BoD deliberations were rushed (only 2 hours) because two directors needed to leave. Evidence of expenses seems available. Threat from OLCNIO is in undoing RTI's long-term plans (VN) – directors may be sufficiently familiar with value of company strategy, having discussed it in the past. But no apparent expertise in identifying lowest price OLCNIO could be acquired; no evidence that movie addresses VN's problem; and no evidence of expected benefit to VN sales from movie.
 - (2) Experts: Directors relied on report by Alan's firm, ordered by Rachel, to understand why VN was failing. PR firm should have expertise in understanding consumer behavior. Independence is not affected because the affected directors, Alan & Rachel, lack CoI. Directors also didn't abdicate decision – report only explained what went wrong, a question framed by Rachel; directors independently considered the evidence in deciding how to improve VN's fortunes.
- (iii) Corporate waste: Waste is a decision so one-sided that no reasonable business person could conclude the corporation received adequate consideration. This rare exception likely fails regarding the movie: while expensive, movie purports to address a weakness identified by an expert report in RTI's flagship product. In tender offer, RTI is buying \$100M in cash for \$150M – immediate loss of \$50M. But this removes threat to RTI's long-term plans, and amounts to a \$50M greenmail, which is analyzed under *Unocal* rather than as waste. Waste claim fails.
- (iv) BJR likely rebutted for lack of reasonable investigation: reliance on report was appropriate, but report wasn't dispositive to BoD's decision. Given decision's importance, directors took too little time to analyze whether movie will yield benefits exceeding considerable cost, and whether tender offer can succeed at lower price. Decisions breach DoC because condoning the faulty process is grossly negligent.³

Conclusion: Rebecca wins DoC claim & (for tender offer) also both prongs of *Unocal*.

2. Sarah's suit

- (a) Sarah's suit is direct – Holdings' tender offer didn't harm RTI; it only affected who controls RTI. If Sarah can demonstrate FD violation, it wouldn't require showing harm to RTI (direct suit under *Agostino*); since both the harm and benefit of remedy (rescission or damages) are to Rachel as a SH, the suit is direct under *Tooley*.

³ DoC exculpation in AoI, which may be authorized by DGCL 102(b)(7), is irrelevant here, since it exculpates directors from personal liability for damages; Rebecca seeks an injunction.

(b) Duty: Rachel acted as RTI's SH, not as officer/director, so she owes FD only if she's RTI's controller. Likely, she isn't: when tendering, she owned 20% (and wasn't affiliated with other SHs) while Sarah has 30%. However, she's a large SH & CEO, controlled RTI before Sarah bought shares and following the tender offer. Therefore, small chance that court might find control.

(c) SoR: If Rachel is RTI's controller & is on both sides of the deal, SoR is entire fairness (*Kahn*).⁴ Argument for applying *Kahn*: Rachel may use control to prevent RTI's BoD from implementing takeover defenses that block Holdings from acquiring RTI shares. But RTI SHs aren't coerced to participate as they would in a freezeout, so deal is effectively a tender offer for RTI shares by a Rachel-controlled firm: no DoL other than disclosure (*Solomon*). Rachel's influence on RTI's BoD would be analyzed under *Sinclair/Hammons*: BJR applies because Rachel didn't receive "something from the subsidiary to the exclusion of, and detriment to, the minority stockholders."

(d) Application: Controllers owe DoC when selling shares (*Harris*), but Holdings isn't a looter and as Holdings' controller, Sarah is selling to herself, so no liability.

(e) If *Kahn* applies (unlikely, see (b)-(c)), entire fairness SoR applies & Rachel has BoP because no robust procedural protections were implemented. However, Rachel is likely to prove that the tender offer was fair because she received no better terms than MSHs (one Holdings share per RTI share tendered; she even received less than MSHs if one considers the \$5M paid for the first share).⁵

⁴ Rachel is definitely on both side of the deal from Holding's perspective (she's selling shares to Holdings and as Holdings' controller sets the terms offered by the buyer), but Sarah is not a Holdings SH, but an RTI SH, so the issue is whether Rachel is on both sides of the deal from an RTI SH's perspective; i.e., is she both on the side of other RTI SHs and at the same time uses her control of RTI to advance interests on the opposite side of the deal.

⁵ Some students argued that Holdings' offer to acquire only Class A of RTI's shares violated Rule 13e-4(f)(8)(i). This is wrong for two reasons: (a) The rule only applies to issuer tender offers, and here the tender offer is not by the issuer (RTI) but by Holdings; (b) The rule requires opening the tender offer to all SHs of the class subject to the tender offers. Here, the class subject to the tender offer is Class A shares, while the excluded shares are class B shares. They have identical voting and economic rights, but are nonetheless different classes.