

**University of Illinois College of Law  
Examination Cover Sheet**

**Business Associations 2**

Professor Amitai Aviram

Spring Semester 2011

Number of Pages: 6 (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 4, 5, 6, or 9. 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 the Restatement (Third) on Agency, RUPA, Delaware corporate law and U.S. securities 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**

**The early history of Medina:** Isabel Medina (“Isabel”) graduated with a Ph.D. in chemistry in 1935. Brilliant and unconventional, Isabel had discovered during her doctoral research a process to produce a gasoline-substitute from pomegranate peels. Upon graduating, Isabel formed Medina Corp. (“Medina”), incorporated in Delaware, to exploit the commercial potential of this invention. Medina had one class of stock, with 10,000 shares authorized & 1,000 shares outstanding (all issued to Isabel).

Conventional wisdom was that there was no commercial potential to exploit in Isabel’s invention. First, gasoline prices were much lower than the cost of producing the pomegranate-peel-gasoline-substitute (“PPGS”). Second, not many pomegranates were grown in the US at the time, so pomegranate peels were hard to come by.

Isabel did not give up, and spent the next two decades improving the process. By 1955 the process was much more efficient, with the cost of PPGS dropping almost by half. However, gasoline was still much cheaper. Medina sold about one PPGS machine a year – just enough to cover costs. In the early 1960s Isabel brought her two children into the business. The older brother, Victor, was hired as Vice President of Research & Development. The younger brother, David, was hired as Vice President of Finance.

Coincidentally, this was a turning point for Medina. Demand for pomegranates soared in the 1960s, resulting in a large increase in the number of pomegranate trees cultivated and thus in the amount of available pomegranate peels. Then, in 1973 a global oil crisis quadrupled gasoline prices and increased interest in reliable and domestically produced energy sources. Medina’s PPGS machines sold like hot potatoes, and profits soared.

**David’s failure:** Medina began to be seen as an attractive investment. David handled negotiations with various suitors to sell a stake in Medina, but time and again backed out because he believed the company would be worth even more a few years later. Isabel did not fault David for any particular failed deal, but grew frustrated at his cautiousness.

Finally, a short recession in 1980 shook up David’s optimism and persuaded him to sell a stake in Medina quickly, before another recession endangered the company’s prospects. To facilitate a deal, David asked that Medina create a second class of shares that would be sold to potential investors. At David’s request, Medina’s BoD and SH meeting approved changes to the AoI that renamed the original shares as A-shares (maintaining the number of authorized shares at 10,000), while a new class of shares was called B-shares, with 1,000 B-shares authorized. The AoI stated that B-shares would have voting and economic rights as will be determined by a resolution of the BoD, and could be made redeemable or convertible into A-shares if and as determined in a resolution of the BoD. This was done at David’s request, to provide flexibility in negotiating with investors.

In mid-1981, just as negotiations with investors were nearing conclusion, the US entered a “double-dip” recession (a second recession shortly after the first one ended). Investors suffered surprising losses and shied away from new investments, dooming the plans to sell a stake in Medina to outsiders.

Meanwhile, Isabel was aging and wanted to appoint a successor and retire. Having lost patience with David's cautious approach, she endorsed Victor as her successor as CEO of Medina – a decision that was approved by the BoD.

**Victor's failure:** The 1973 oil crisis and the following 1979 energy crisis convinced Victor that the trend towards more environmental regulation of the energy industry would reverse. The interest in energy independence would outweigh the interest in a clean environment, he reasoned. Therefore, he had Medina focus its research and development efforts into a new technology that produced gasoline-substitutes from coal ("dirty coal"). This technology was cheap (expected to become cheaper than gasoline after a few years of improving the process) and there was enough coal in the US to satisfy gasoline demand for several hundreds of years, but the process caused horrendous pollution. The economic viability of the process depended on persuading Congress, in the interest of energy independence and affordable gasoline, to pass a law immunizing the industry from tort liability for the pollution they caused.

Victor's plan backfired. Even after several years and tens of millions of lobbying dollars, Congress refused to pass the pollution immunity bill Medina was pressing for. Medina's lobbying caused a backlash that increased environmental regulation and severely tarnished Medina's public image. This hurt Medina's sales of PPGS machines. Meanwhile, Medina's aggressive research and development efforts into dirty coal technologies employed several hundred workers but were not producing any revenue.

By 1985, Isabel was terminally ill and wanted to leave her last mark on Medina. She was upset that Victor had tarnished Medina's reputation, and had come to appreciate David's cautious approach. Isabel invited her sons and told them that she wanted David to run Medina. To facilitate this, she told them she would bequeath 501 of the 1,000 shares she owned to David, and the other 499 to Victor.

Isabel wanted David to inherit a "clean slate" as CEO, so she forced Victor to shut down the dirty coal division and fire the several hundred workers employed there. Victor then resigned as CEO and David was appointed. Isabel died a few months later, and her shares were passed as planned (501/499) to David and Victor.

**Fast forward to the present:** In the 25 years that followed, Medina had known ups and downs, but generally fared well under David's management. It became one of the largest non-public clean-energy companies. Currently Medina's BoD consists of five directors: David, Victor, Amanda (an investment banker with expertise in clean energy companies), Brett (a partner at a large law firm, with expertise in tax and corporate law), and Charles (a distinguished professor at the University of Illinois' Center for Advanced BioEnergy Research).

The relationship between David and Victor (and their families) became strained in the years following the events of 1985. Victor had no regrets about the way he managed Medina when he was CEO. The "dirty coal" policy, he still believed, was correct and would have succeeded with a bit more lobbying if Isabel had not forced him out.

However, Victor was wracked with guilt about the employees he fired, feeling that he failed them when he bowed to his mother's pressure. He kept in touch with all 469 former employees throughout the years.

**Where there's a will...**: Recently, Victor's health has deteriorated. In a final attempt to atone for past mistakes, Victor wrote his will, in which he bequeathed one of his shares in Medina to each of the employees that he fired. The remaining 30 shares were bequeathed to specific former employees (among the 469) who, to Victor's knowledge, had particularly difficult financial situations.

When Linda (David's daughter and Medina's General Counsel) learned about the will, she became concerned about what it would do to Medina's tax status. Medina qualified for particular tax treatment as an S-Corporation. Federal regulations required, among other things, that S-Corporations have no more than 100 shareholders. If Victor's shares passed to the 469 former employees, then Medina would no longer qualify as an S-Corporation and would lose the tax benefits of that status. Linda informed David and the BoD of her concerns.

The next BoD meeting's agenda included discussion of the impact of Victor's will on Medina. At that meeting, Linda explained the tax problems that would be caused by Victor's will. David then made a personal plea to Victor to allow Medina to buy back his shares, allowing him to bequeath the money as he saw fit. "The last valuation we have for Medina, from five years ago, valued each share at \$250K," said David, "what if we offered you \$300K per share?"

Victor responded that he felt the only way he could atone for firing the employees was by making them owners in the company they were forced out of, so he would not sell the shares at any price.

Having anticipated Victor's refusal, Linda proposed to the BoD the following steps ("protection plan"). First, the BoD would issue a resolution that would state that: (i) B-shares have voting rights, rights to dividends and rights at dissolution equal to 1/1,000 of an A-share (i.e., 1,000 B-shares have the same rights as 1 A-share); (ii) the BoD may redeem B-shares at any time, at a price of 1 cent per share; (iii) should there occur a transaction that increased the total number of shareholders owning shares in Medina and that did not receive prior consent from the BoD ("unauthorized sale") – each B-share, except for shares owned by a party to the unauthorized sale, would convert automatically into 9 A-shares, and all B-shares owned by parties to the unauthorized sale would automatically be redeemed for 1 cent a share.

Second, the BoD would issue 1,000 B-shares and distribute them as a dividend to A-shareholders (so that each shareholder would receive 1 B-share for every A-share they currently own).

The BoD discussed the proposal, with Amanda and Brett being particularly active both in questioning Linda on the details of her plan and in explaining to the other directors Medina's tax problem and the pros and cons of Linda's proposal. Finally, the BoD voted 4-1 (with Victor voting against) to issue the resolution fixing the terms of B-shares, and to issue and distribute the B-shares as Linda recommended.

**Plan B:** Victor sued, challenging the protection plan for breach of fiduciary duties. While the suit was pending, Linda developed a backup plan (the “reverse split”) in case Victor’s challenge to the protection plan was successful. Under this plan, Medina’s A-shares would have a 500:1 reverse split, meaning that each 500 outstanding A-shares would become a single A-share. This would result in David owning 1 A-share and a 1/500 fraction of a share, and in Victor owning a 499/500 fraction of a share. Medina would then acquire the share fractions in return for their fair value. This would result in Medina having only one A-share outstanding – owned by David.

To execute this plan, Linda determined that the following steps needed to be done. First, the BoD should recommend to the shareholders an amendment to Medina’s AoI that would state that: (i) the authorized number of A-shares is 2 shares; (ii) every 500 A-shares that are outstanding at the time of the amendment become a single A-share; (iii) Medina is not allowed to issue fractional interests (share ownership that is less than 1 full share); (iv) shareholders who would have had a fractional interest following the reverse split will receive from the company, in lieu of the fractional interest, a payment in cash of the fair value of their fractional interest.

Second, the BoD should call a shareholder meeting to approve the AoI amendment. Third, subject to the adoption by the shareholders of that amendment, the BoD should authorize Linda to pick an expert to determine the fair value of Victor’s and David’s fractional interests, and to make cash payments to shareholders in lieu of fractional interests (as instructed by the AoI amendment). As soon as this was done, Linda said, the BoD could decide to abandon the protection plan (or, if it were already implemented, to redeem all B-shares for 1 cent each (\$10 total)).

This plan was presented to the BoD, and the BoD deliberated (again, with Amanda and Brett being particularly active in both questioning Linda and explaining the plan to other directors) and voted 4-1 (again, with Victor voting against) to do the three steps that Linda suggested (amendment recommendation, calling a SH meeting, and authorizing Linda). The shareholder meeting was called and conducted appropriately following all required procedures. At that meeting, David voted his 501 shares in favor of the amendment and Victor voted his 499 shares against. Victor sued, challenging the reverse split for breach of fiduciary duties.

**Discuss Victor’s suits challenging: (1) the protection plan; and (2) the reverse split.** Defendants waived, and you should not discuss, claims related to whether the suits are derivative.

## **Question 2**

Note: The effective date for this question is **April 20, 2011**. 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, 2011 10:45 PM

**To:** Ms. WIZ Mailing List

**Subject:** CONFIDENTIAL – Project Genealogy

You've been assigned to work with me on Project Genealogy. A private equity firm called Spectrum Equity Investors ("SEI") has hired us to advise and assist them in acquiring 100% of Ancestry.com Inc. (Nasdaq: ACOM). SEI intends to use mostly borrowed money to finance the ACOM acquisition, but has yet to decide who it will borrow from. SEI has contacted ACOM's CEO Timothy Sullivan, telling him about its planned acquisition, stating that SEI is impressed with ACOM management's performance and assuring him that, if the acquisition succeeds, SEI has no intention of replacing him or the rest of the current management team.

Your assignment is straightforward: write a memo to SEI identifying what obstacles exist to this acquisition, anticipating how ACOM might respond, and explaining how SEI should proceed to acquire ACOM with minimum legal risks.

Thanks and good luck!

[Note: SEI is a real company, but it is not publicly-held. You should only use publicly available information on SEI.]

## Business Associations 2 – Spring 2011: Answer to Question 1

### 1. Protection plan

(a) **Classification (BJR or Unocal?)**: The protection plan is a “flip-in” poison pill, but its purpose is to maintain tax advantages for Medina (not a takeover defense).<sup>1</sup> *Unocal* protects against entrenchment when BoD deploys corporate power against SHs to achieve greater good for corporation (as here). In *Selectica*, poison pill designed to maintain tax advantages (as here) was reviewed under *Unocal*. However, *Selectica* pill had side effect of preventing takeovers and therefore entrenching the BoD. Conversely, the protection plan triggers when share ownership becomes less concentrated (# of SHs increases), which doesn’t present an entrenchment concern. Furthermore, Medina has one controller (David), so BoD cannot entrench itself. Possibly *Unocal* applies, but more likely BJR.<sup>2</sup>

(b) **Screen – Unocal**: If *Unocal* applies, BoD probably wins.

(i) Did BoD find, in good faith & after a reasonable investigation, that Medina faced a threat that warranted the defensive action? Yes.

(1) The threat they identified was losing the tax status of an S-Corporation.<sup>3</sup>

(2) BoD conducted reasonable investigation: Decision of moderate importance (limits share transferability, but end SH’s participation in the company). Brett and Amanda have the tax, corporate and financial expertise to understand the threat and assess the plan, they questioned Linda and explained the plan to the other directors.

(3) Directors acted in good faith – they seem interested in maintaining tax advantages for Medina, not in settling scores with Victor.

(ii) Was defensive action a reasonable response proportionate to threat posed? Probably yes.

(1) Not coercive: SHs’ voting is not affected at all, and SHs aren’t forced to sell their shares to anyone.

(2) Probably not preclusive: if BoD refuses a transaction, the BoD can be replaced in next SH meeting.<sup>4</sup>

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<sup>1</sup> As some students pointed out, the protection plan may not matter because IRC §1361(b)(1)(D) requires S-Corporations to have only one class of stock. Of course this is not part of the course material and you were not expected to mention this issue. Students who were aware of this received extra-credit if they presented it in an argument questioning reasonable investigation by the board or questioning Linda’s expertise as General Counsel. However, this issue is not dispositive to the *Unocal* analysis, since directors may be entitled to deference even when their actions are ultimately mistaken (on a matter of fact or of law), as long as they acted in good faith, after reasonable investigation, and in a way proportionate to the threat they perceived.

<sup>2</sup> Fact pattern states that Victor challenged the protection plan for breach of FD, so there was no need to discuss arguments regarding authority. If authority were also challenged, the challenge would have failed. BoD is authorized to designate and issue the protection plan stock. DGCL 151(b) allows redeemable stock, DGCL 151(e) allows convertible stock, and DGCL 151(a) allows BoD resolution to set terms of stock if AoI authorizes it. DGCL 152 authorizes BoD to issue stock.

<sup>3</sup> This doesn’t fit into any of the three *Airgas* categories, but this is because *Airgas* analyses threats related to takeover defenses. In *Selectica*, court accepted threat to tax status as a valid threat.

<sup>4</sup> BoD likely won’t be replaced if David wishes to maintain the plan, but this is not a preclusion concern, since it does not suggest BoD is unaccountable to SHs, but the opposite: that BoD does what the majority SH wants. If this amounts to oppression of the minority SH (Victor), David may be liable under *Sinclair* (see 1(e)), but it does not run afoul of *Unocal*, which is concerned with BoDs being unaccountable to SHs.

(3) Proportionate: poison pill is a rational way to deter share sales that endanger the tax status. In a close corporation like Medina, a restriction on share transferability may work better, but it limits SHs more than the protection plan, so this alternative does not make the protection plan disproportionate.

(c) **Screen – BJR:** If BJR applies, BoD wins. Protection plan adopted in good faith to prevent loss of tax benefit (no illegality, corporate waste or improper purpose). No carelessness (see 1b(i)(1)). Perhaps David has CoI (see 1(e)(i)), but majority of BoD does not, so decision is not tainted by CoI. BJR upheld.

(d) **Duty/Breach:**

Duty: Defendants owe FD as directors. Breach: In unlikely case BoD loses on BJR/*Unocal*, protection plan doesn't breach FD because it is fair – reasonable, proportionate way to protect Medina's tax status (see 1(b(ii))).

(e) ***Sinclair*:**

(i) Classification: David may violate FD as controller by effecting conflicted action: protection plan restricts minority SHs' ability to transfer shares, but not his own (since restriction is subject to BoD approval & David possibly controls BoD).

(ii) Duty: David owes FD as SH if he controls Medina. He owns majority of Medina's shares and actively manages Medina, but in role of CEO, not SH. No evidence of dominating BoD, though his daughter is dominant force behind protection plan. Borderline case. If David doesn't control, *Sinclair* claim fails.

(iii) If David controls Medina, *Sinclair* test replaces BJR: does David receive something from Medina to the exclusion of, and detriment to Victor? Perhaps. If David does control BoD (prerequisite for *Sinclair* liability), protection plan restricts Victor but not David, so Victor is detrimentally excluded from freely transferring his shares while David isn't.

(iv) Breach: fairness test – protection plan is fair (see 1(b(ii)/1(d))).

## **2. Reverse split**

(a) **Classification (BJR or CNX?):** The reverse split is a controller freezeout, since it eliminates minority SH's ownership and transfers 100% ownership to David. This isn't a merger so Victor has no statutory appraisal rights (DGCL 262), but FD would be violated if controller offered and BoD accepted an unfair price.<sup>5</sup> As controller freezeout, standard is likely *CNX*, not BJR.<sup>6</sup>

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<sup>5</sup> Some exams cited the doctrine of independent legal significance to support an argument that we should not treat the reverse split as a freezeout merger. This is a correct argument for why there is no appraisal right, but it does not affect the question of whether a fiduciary duty exists to offer fair terms to minority SHs, since that duty exists not just in mergers, but in any action that a controller takes. David would owe it not because the freezeout is deemed a merger (which it wouldn't be given the doctrine of independent legal significance), but because the freezeout potentially forces minority SHs out under unfair terms. *CNX*, rather than *Sinclair*, is the appropriate standard because *CNX* is specific to freezeouts, while *Sinclair* is a more general standard.

<sup>6</sup> Fact pattern states that Victor challenged the reverse split for breach of FD, so there was no need to discuss arguments regarding authority. If authority were also challenged, the challenge would have failed. DGCL 242(a)(3) allows AoI amendment to facilitate reverse splits, DGCL 242(b) requires amendment approval by both BoD and majority of outstanding shares, which it received. DGCL 155 addresses BoD's handling of fractional shares, but it was not part of the assigned material.

(b) **Duty**: Defendants owe FD as directors; David is also liable as the controller in a controller freezeout (*CNX*).

(c) **Screen – CNX**: Under *CNX*, controller freezeout is subject to entire fairness review, unless:

(i) Transaction (reverse split) negotiated & approved by special committee of independent directors – did not occur here, though all independent directors voted in favor of transaction.

(ii) Transaction was conditioned on affirmative vote of MotM SHs – here, AoI amendment was not conditioned, and did not receive any minority SH votes.

Transaction fails *CNX* review, so entire fairness applies.

(d) **Screen – BJR**: If BJR applies, it will be rebutted because BoD's reliance on a valuation expert selected by Linda is unsupported by DGCL 141(e), both because BoD abdicates its duty to determine this important element of the reverse merger, and because Linda has CoI, which taints the expert she picks. Linda has CoI because her father would benefit from having Medina pay a low price (since he will own all of Medina, and Medina will pay Victor for 499/500 share, and to David for only 1/500 share).

(e) **Breach (entire fairness)**: Fair price? Not assessable (no price determined at this point). Fair process? No. Price determined by expert picked by conflicted Linda (see 2(d)); AoI vote received no minority SH votes. These outweigh independent directors' approval. FD breached.