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

Business Associations I

Professor Amitai Aviram

Fall Semester 2005: Dec. 8/10, 2005

Number of Pages: 12 (including this page)

Time Allotted: 4 hours

Exam Instructions

General instructions (for both Part I and Part II of the exam):

1. **Permissible material:** This is an open book exam. You may use any materials you want, whether in hardcopy or electronic format. You may not communicate with anyone about the exam until it is over, and you may not access the internet while taking the exam.
2. **Anonymity:** The exams are graded anonymously. Do not put your name or anything else that may identify you (except for your student number) on the exam.
3. **Confidentiality:** 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). Similarly, 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 form.
Breaching this duty of confidentiality will be considered a violation of the honor code and the breaching student will be subject to disciplinary action. After the last day of the exam period for this semester, you are allowed to freely discuss the contents of the exam.
4. **You must return this exam form, and any notes you take during the exam, together with your answers.** A student who did not submit the exam form at the time the exam was submitted will be seen as if he/she did not submit the exam, and will receive zero points on the exam.
5. **“Fact” patterns are fiction:** The “facts” presented in the exam were constructed for an educational purpose, and were not intended to refer to or inform about any real person or event.

Good Luck!

Part I – Essay (60%):

Specific Instructions for Part I (Essay):

1. **Length limit:** The length of your answer to the essay portion of the exam is limited as follows:
 - a. If you type the exam on a computer, it should not exceed 800 words. If you handwrite your exam, it should not exceed 80 lines.
 - b. **For every 10 words (typed exams) / 1 line (handwritten exams) in excess of the length limit (rounded up), one point will be taken off the exam’s raw score.**
 - c. If you type your exam, please write at the end of it the word count (e.g., “Word Count: 719 words”). If you handwrite your exam, please do a similar line count. The words/line used in reporting the word/line count are not calculated in the word/line count itself. **Failure to do so will result in a reduction of one point from the raw score.**
2. **Legibility:** If you handwrite your exam, please write legibly. I will do my best to read your handwriting, but will have to disregard (and not give you points for) writing that is too small to read or otherwise illegible.
3. **Writing the exam**
 - a. You should give appropriate case and statutory authority for your answers, stating how each cited case/statutory provision relates to your answer.
 - b. Length limit permitting, answer all issues that arise from the fact pattern, even if your conclusion on one of the issues is dispositive to other issues.
 - c. If you think a question is unclear or cannot be decided without additional facts, state clearly what facts you believe to be necessary to answer the question. Length limit permitting, try to discuss the applicable rule and result for the various possible fact patterns.
4. **Applicable law**
 - a. If a question specifies the applicable law, then assume that the relevant jurisdiction applies that law.
 - b. If a fact pattern specifies the applicable law (and the specific question does not specify applicable law), then assume that the relevant jurisdiction applies that law.
 - c. If neither the question nor the fact pattern specified the applicable law, then apply the law we addressed in the course. If the issue was addressed differently in different jurisdictions, then state the rule, application and result in each jurisdiction we addressed.
5. **Choice:** The essay part of the exam contains two questions. You have a choice of answering either of them. I will only grade the question you answered first.

Essay Fact pattern (answer EITHER question 1 or 2):

For the purpose of both questions, assume that Restatement (Second), RUPA, and DGCL apply.

Since her college days, Maya exhibited an exceptional ability to identify promising businesses. She invested the money she earned as a waitress in stocks of undervalued companies, and used the profits to cover her living expenses and tuition in college. After graduating, she was hired by an investment bank and worked for a few years as an analyst. Then, she resigned her job to start her own asset management business.

Maya persuaded her friend Frank to let her invest \$100,000 of Frank's savings for five years. Maya will receive 30% of the profits. Frank, who is a business journalist, has access to plenty of (public but frequently unnoticed) information on various companies, and told Maya that he would forward that information to Maya in case the information helps Maya identify business opportunities.

After doing some research, Maya identified a promising corporation called Etti-cat Corp. ("Etticat"), a pet finishing school that teaches cats proper manners. Etticat has as single class of stock, of which it has 1,000 authorized shares. Etticat's CEO and only shareholder, Ethan, owns 500 shares; all the other shares are authorized but unissued.

Maya contacted Ethan, who offered her newly issued shares of Etticat for \$500 a share. Because Etticat needed cash to expand, Ethan suggested that if Maya purchased 200 shares (for \$100,000), she would receive a bonus of 50 shares. Maya agreed, paid Etticat \$100,000, and received 250 newly issued shares of Etticat.

Maya told Frank that she purchased 200 shares of Etticat for \$500 a share, and said that she (Maya) owned 50 shares herself, but did not mention that she received these shares as a bonus.

The following month Frank wrote an article on a company called The Rust Belt, which manufactures belt buckles. Frank spoke with The Rust Belt's owner, Russ, who offered to sell him 100 shares of The Rust Belt for \$100,000. Frank offered Russ 200 shares of Etticat instead of cash, and Russ agreed. They agreed to trade 100 shares of The Rust Belt for 200 shares of Etticat. Frank told Russ that Maya is holding his Etticat shares, and therefore asked Russ to collect the Etticat shares from, and deliver The Rust Belt shares to, Maya.

When Russ contacted Maya, she researched The Rust Belt and concluded that it is not as good an investment as Etticat. She told Russ that Frank had no power to trade the Etticat shares, and that she (Maya) is not bound by the agreement. Russ sued Maya to enforce the stock barter agreement he reached with Frank. Frank sued Maya, claiming that the 50 Etticat shares that Maya received as a bonus belong to him.

1. Analyze both Russ' suit and Frank's suit.

Maya settled the lawsuits with Russ and Frank. At the end of the settlement, Ethan owned 500 shares of Etticat, Russ owned 200 shares, and Maya owned 50 shares. Etticat needed yet more money to expand, so it issued another 250 shares to new investors (each of the new investors purchased no more than ten shares). In the next shareholder meeting, Ethan, Russ and Maya were elected as directors. The board of directors then elected Maya as Etticat's new CEO and President, replacing Ethan.

The company changed its strategy after Maya became CEO and President. To make the most of Maya's talent in identifying promising investments, Etticat shifted its focus away from cat etiquette and into general investment. Etticat bought two companies (a restaurant and a plumbing company), and sold the companies a few months, when their value increased. The profits were used to make larger investments, in other companies. Eventually, Etticat sold its cat etiquette business, and Etticat's only business became investing in other companies. Because Etticat was now a large company, it did not bother to consider investments that were smaller than \$1 million.

While analyzing data to identify new investment prospects, Maya learned about Pez Depot, Inc., an Internet marketplace to buy and sell Pez candy dispensers. Because Pez Depot was a small company, the maximum possible investment was \$50,000.

In the next board meeting, Maya reported that an investment in Pez Depot is likely to yield a nice profit, but it was, in her view, far too small an investment for Etticat to bother with. Maya asked the board to allow her to invest in Pez Depot with her own money. Maya then gave Ethan and Russ copies of her detailed analysis of Pez Depot, and left the board meeting. Russ and Ethan read Maya's report, but decided that neither of them knew enough about Internet companies to evaluate Maya's analysis.

They hired Xavier, an experienced Internet stock analyst, to review Pez Depot and Maya's report. Xavier reported back that he concurred with Maya's analysis, that an investment in Pez Depot is likely to yield an above-average profit. Xavier did not address the question of whether the investment is too small for Etticat. The board convened again, with Maya refraining from attending the meeting. Both Ethan and Russ read and discussed Xavier's report. Ethan said that he recognizes that Pet Depot is a promising investment, but agrees with Maya that Etticat should not bother with small investments. Russ questioned why Etticat should decline any opportunity to make a profit. At the conclusion of the discussion, Ethan and Russ voted. Ethan voted for Etticat to decline the investment, and allow Maya to invest in Pez Depot. Russ abstained.

Following the vote, Maya invested her own money in Pez Depot. Meanwhile, she learned about another small but promising investment – Joe le Taxi Corp. ("JLT"), a small cab company. Again, the maximum investment was \$50,000, and Maya invested her own money in JLT, without informing the board about this investment opportunity. Etticat does not have any investments in companies that are in the same or a related industry to those of Pez Depot or JLT.

Both investments yielded generous profits. Shelly, who owns a share of Etticat, sued Maya for breach of her duty of loyalty in personally investing in Pez Depot and JLT, rather than allowing Etticat to invest in them. Steve, who also owns a share of Etticat, sued Ethan and Russ for breaching their duty of care in allowing Maya to invest in Pez Depot, and in failing to take actions that would have detected and prevented Maya from investing in JLT.

2. Analyze both Shelly's suit and Steve's suit.

Student Number _____

Business Associations Final Exam
Part II – Multiple Choice (40%):

Specific Instructions for Part II (Multiple Choice):

1. **Mark the best answer to each question on the bubble sheet.**
2. **Use a pencil to fill the appropriate bubble on the sheet.** Make sure that you completely fill the chosen bubble.
3. **Do not mark more than one answer per question.** Filling more than one bubble for the same question will count as an incorrect answer.
4. **Scoring:** You will receive four points to your raw score for each correct answer and zero points for each incorrect answer.
5. **Applicable law**
 - a. If a question specifies the applicable law, then assume that the relevant jurisdiction applies that law.
 - b. If a fact pattern specifies the applicable law (and the specific question does not specify applicable law), then assume that the relevant jurisdiction applies that law.
 - c. If neither the question nor the fact pattern specified the applicable law, then assume that the relevant jurisdiction applies the following laws: Restatement (Second) on Agency, RUPA, MBCA and all Federal laws.
 - d. If (c) should apply but we did not discuss in class the rule according to the jurisdictions mentioned in (c), then apply the law we discussed in class.
6. **Choice:** This part of the exam contains 12 questions, **of which you should answer ten.** If you answer more than ten questions, you will be graded on the ten best answers (e.g., if you answered all 12 questions, and ten, 11 or 12 of them were correct, you will be credited with ten correct answers).

[My policy is to maintain confidentiality of the multiple choice portion of my exams and the answers to them. The multiple choice portion is therefore omitted.]

Business Associations I – Fall 2005
Memo on the Final Exam

Grades:

Raw scores were calculated out of a total of 100 points – 60 for either question I(1) or I(2) and 40 for part II (Multiple Choice). Below are the average, median, lowest and highest grades for the exam and for each question separately:

	Average	Median	Lowest	Highest
Entire Exam	63.90	67	26	91
Part I(1) [60%]	30.78	36	2	47
Part I(2) [60%]	30.29	31	13	46
Part II (Multiple Choice) [40%]	32.32	32	16	40

Grades were given based on the percentile ranking of the exam's total raw score, fitted into the curve imposed on classes of over 20 students. Therefore, a grade depended not on the absolute raw score of the exam, but on the relative ranking of a given exam's raw score compared to all other exams' raw scores).

Below is an outline of what would constitute an excellent exam. This is only an example, not the example; i.e., some students received credit for very different, but well explained and correct responses.

Part I (Essay)

1. Russ' & Frank's Suits

(a) Is Maya Frank's agent? Probably yes. Test is in Restatement §1:

(i) Frank manifests consent that Maya will act on Frank's behalf? Yes (Maya invests Frank's money).

(ii) Frank manifests consent that Maya will act subject to Frank's control? Probably yes – Frank does not control the physical conduct (the specific investment decisions), but does specify the end result – managing Frank's money for five years.

(iii) Maya's consent – Yes.

(b) Frank's suit – if Maya is Frank's agent: The 50 Etticat shares that Maya received were a secret profit that was received as part of executing Maya's responsibilities as an agent (*Reading*). The disclosure of their ownership without the disclosure of the reason they were received does not amount to full disclosure, so Frank cannot be seen as ratifying Maya's "bonus". If Maya is Frank's agent, she must disgorge the shares to Frank (but is entitled to 30% of the profits as compensation).

(c) Russ' suit – if Maya is Frank's agent: The agency agreement has a term of five years. However, both principal and agent always have the power to terminate an agency relationship, even when they do not have the right to do so. Frank's sale of the Etticat

shares is an implied termination, and Maya must return Frank's investment (or, in this case, surrender it to Russ, who bartered it from Frank). Frank may be liable to Maya, though.

(d) Is the agreement between Maya & Frank a partnership? Partnership is an "association of two or more persons to carry on as co-owners a business for profit" (RUPA § 101(6), 202(a)). There are two people and the business is for profit. Co-ownership means sharing control and sharing profits. Shared profits create a presumption of partnership, but not if they are received for services of an independent contractor or wages or other compensation as an employee (RUPA §202(c)(3)). Here there are shared profits (Maya receives 30% of the profits), but they may be seen as compensation for Maya's services.

(i) Shared control is questionable: The agreement seems to imply that Maya has sole discretion about investing the money for the agreement's duration (it would be difficult to manage money if Frank could meddle with Maya's investment strategies). But there might be shared control in that Frank addresses one aspect of the business (supplies information), while Maya addresses another (investment decisions).

Conclusion: Close call. I think there's joint control, and therefore a partnership.

(e) Frank's suit – if Maya is Frank's partner: The 50 Etticat shares were partnership assets because they were provided to the purchases, which was the partnership (through Maya acting as partner). As a partner, Maya is the partnership's agent when acting for the purpose of partnership business (RUPA §301(a)), so even if she received the Etticat shares in her personal capacity, they would be secret profits (see 1(b)), which belong to the agent (the partnership). If Maya is Frank's partner, she must disgorge the shares to the partnership (70% go to Frank).

(f) Russ' suit – if Maya is Frank's partner: An act of a partner for apparently carrying on in the ordinary course the partnership business binds the partnership, unless the partner had no authority and the third party had notice of the lack of authority (RUPA §301(a)). Since the partnership's business is investing in companies, buying and selling shares is in the ordinary course of business. Frank likely has no authority (see 1(d)(i)), but Russ doesn't have notice of that.

(i) However, Russ may not know of the partnership's existence, thinking that he is contracting with Frank, not with the partnership. Frank as the agent of the partnership can only bind it if he has authority. He does not have actual authority (see 1(d)(i)). Since Russ does not know about the principal, there cannot be apparent authority. A requirement for inherent authority (in the case of undisclosed principals, and where the agent is not appointed as a manager) is that the acts are usual or necessary in transactions the agent is authorized to conduct (Restatement §194, *Watteau*). Here Frank is not authorized to invest (only to provide information), so he lacks inherent authority to sell shares. Maya rejects the agreement with Russ, so there is no ratification. Estoppel seems irrelevant here since Russ did not change his position in reliance on the deal, nor did Russ believe that he entered the transaction with the partnership (Restatement §8B).

Conclusion: Frank is the partnership's agent, but Russ does not know about the

partnership and Frank lacks any type of authority to bind the partnership. Maya does not have to deliver the shares to Russ (Frank may be liable to Russ, though).

[Some students pointed out an issue of standing – Russ may not have standing to raise any rights Frank may have as a principal regarding the shares (he would have standing if Frank is a partner). Extra-credit was given for raising this issue.]

2. Shelly's and Steve's Suits

(a) Shelly's suit – Pez Depot

(i) Maya's decision not to make Etticat invest in Pez Depot (and to invest in it herself) is a business decision, and courts will defer to it under the BJR unless there is fraud, illegality or conflict of interest (*Kamin, Broz*).

(ii) There would be a conflict of interest and a violation of the Duty of Loyalty if Maya seized a corporate opportunity that belonged to Etticat (Broz). The Delaware test is set in *Guth*: (1) the corporation is financially able to take the opportunity – in this case, yes; (2) the opportunity is in the corporation's line of business – Etticat's line of business is investing in companies. Perhaps the "line of business" is limited to investments over \$1M, though I think this is an artificial limitation; (3) the corporation has an interest or expectancy in the opportunity – here, it seems that the corporation does not have an expectancy since it focuses on large investments; (4) by embracing the opportunity the officer/director would create a conflict between his/her self-interest and that of the corporation – Pez Depot doesn't compete or otherwise conflict with Etticat's other investments, and since Etticat has no interest in making small investments, there seems to be no conflict. It's unclear whether the *Guth* prongs are elements (in which case there is no conflict because of prongs (3)-(4)) or factors (in which case elements (1)-(2) may offset (3)-(4)). Conclusion: I think that even if the *Guth* prongs are factors, this is not Etticat's corporate opportunity.

(iii) If it is nonetheless a corporate opportunity, was it ratified by the BoD? BoD met and voted 1-0 to ratify. A majority of total number of directors constitutes a quorum (DGCL §141(b)). Here, a majority (2 of 3) was present. Ratification requires an affirmative vote of a majority of disinterested directors (analogy to DGCL §144(a)(1)). Here, there are two disinterested directors and one vote is less than a majority. Conclusion: no ratification.

(iv) If it is a corporate opportunity and there was no ratification, there would be no breach if the decision was fair (analogy to DGCL §144(a)(3), *Bayer*). Here, decision is fair if there's evidence that Etticat never makes investments of \$50,000 or less.

(b) Shelly's suit – JLT: Maya's decision is protected under BJR unless it was Etticat's corporate opportunity (see 2(a)(i)-(ii)). The *Guth* test applies in the same way as the Pez Depot investment, resulting in a finding that this was likely not a corporate opportunity and no breach of DoL (see 2(a)(ii)). However, if DoL was breached, there was no ratification by the board. It is likely to still be fair if Etticat never makes small investments (see 2(a)(iv)).

(c) Steve's suit – Pez Depot

(i) Causation: BoD didn't ratify Maya's investment in Pez Depot (see 2(a)(iii)), so Steve's suit seems to lack causation, unless it is based not on affirmatively approving the transaction but on failing to monitor and prevent it (in which case, same analysis as 2(d)).

(ii) If BoD had ratified the transaction, it would not have violated DoC. Courts will defer to BoD decision not to invest in Pez Depot under the BJR (*Kamin, Brehm*), unless the decision is tainted by fraud, illegality or conflict of interest (none here), or the BoD did not conduct sufficient investigation or deliberation (*Van Gorkom*). Here, Ethan and Russ do not have the expertise to evaluate Pez Depot's profitability, but they can rely in good faith on Xavier's expert opinion under DGCL §141(e), since he is an expert in the field and disinterested about the matter. Ethan decides that despite the investment's attractiveness, its size is a sufficient reason to decline it. This may not be the best decision, but it is not corporate waste or irrational (*Brehm*) to specialize only in certain types of investments and reject other profitable opportunities, so BJR applies even decision was stupid (*Kamin*).

(d) Steve's suit – JLT: BJR doesn't apply when no decision is made (*Francis, Caremark*). However, DoC is breached only if a reasonable director would have paid attention to the issue and acquired more information. This would occur if the director had notice of conflict of interest (*Van Gorkom*), wrongdoing (*Francis*), or the decision regards important aspects of the corporation's activities (*Caremark*). Monitoring Maya's investments inherently involves a conflict of interest, so BoD shouldn't rely on her to monitor herself in this respect (*Van Gorkom*). Etticat's main business is investing and Maya is the sole person making investment decisions, so monitoring that Maya uses her skill solely in Etticat's interest is an important aspect of Etticat's business. The board likely needs to place some sort of monitoring mechanism to prevent her from "cherry picking" the best investments for herself (*Caremark*). Conclusion: BoD may have breached DoC in failing to police Maya.