

## University of Illinois College of Law Examination Cover Sheet

### **Business Associations 1**

Professor Amitai Aviram

Fall Semester 2013

Number of Pages: 3 (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**
  - a. You must personally pick up a copy of the exam from Beverly Stewart (Room 324) between 9-10am on one of the following days: December 11, 12, 13, 16.
  - b. You must submit your response as a .doc (Microsoft Word) file e-mailed to Beverly Stewart (bstewart@illinois.edu) no later than 10am on the day after you received the exam. The file name should be your 4-digit exam ID number.
4. **Confidentiality**
  - a. 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.
  - b. Students who are enrolled in this course are not allowed to solicit or receive information about 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, you are allowed to freely discuss the exam.
5. **Length limit:** The total length of your answer may not exceed 1,000 words. For every 10 words in excess of the length limit (rounded up), one point will be taken off the exam's raw score.
6. **Answering the exam:** Cite relevant case and statutory authority. Subject to the length limit, answer all relevant issues that arise from the fact pattern, even if your conclusion on one of the issues is dispositive to other issues.
7. **Assumptions:** Unless the exam question specifies otherwise, assume that -
  - a. The relevant jurisdiction applies the Restatement (Third) on Agency, Delaware corporate law, RUPA, and U.S. securities law.
  - b. Each corporation's charter states that: the corporation is a stock corporation; it has limited liability & perpetual existence; the corporation may conduct any lawful act or activity; the BoD may amend the bylaws; director fiduciary duties are limited to the maximum degree allowed under DGCL §102(b)(7).
  - c. Each corporation's bylaws state that: the chairperson of the BoD is authorized to call a BoD meeting; and the BoD is authorized to call both annual & special shareholder meetings.
8. **"Fact" patterns are fiction:** The "facts" presented in this exam were constructed for an educational purpose, and are not intended to inform about any real person or event.

Prosperity, Inc. (“Prosperity”) is a public Delaware Corporation that invests in real-estate ventures (taking minority positions in real-estate companies). Owen is the founder of Prosperity and owns 65% of its single class of outstanding shares. Prosperity’s BoD is composed of three directors: Owen, Darren (who is also the CEO of a mid-sized bank) and Donna (a professor of accounting).

Since Prosperity’s founding, Owen had been its CEO. Because of his conservative nature, Prosperity has invested in the past only in very safe, high-quality ventures. As a result, it had to pay high prices for its investments, and while Prosperity has been continuously profitable, its profits were low and slowly declining. For several years, Darren pressured the board to change its strategy and invest in some riskier (but potentially more rewarding) ventures. Eventually, Owen was persuaded to give it a try and the board approved hiring Chloe, who had a reputation as a brilliant and contrarian real-estate analyst. Chloe was told to identify and buy for Prosperity promising real-estate ventures, investing up to a total of \$7M.

A few weeks later, a surprising increase in interest rates and news of increased defaults on mortgages caused a sharp drop in real-estate prices and gave Chloe an opportunity to buy. She acquired on behalf of Prosperity some commercial property (“the Property”) for \$6M. The Property was in a risky location, in a market segment that was highly dependent on buyers’ access to financing, so if the real-estate market improved the value of the Property would increase significantly, but if the market worsened the Property would lose much of its value. Chloe reported the acquisition to the board promptly.

About a month passed, and the distress in the real-estate market increased. By one estimate the Property was now worth only about \$5M. At Prosperity’s next board meeting, Owen and Donna said they were uncomfortable having Prosperity take such risks, and suggested that they should dump this investment now rather than risk losing more of its value. Darren warned that a sale now, in a distressed market, would result in receiving a low price, but he eventually agreed with Owen and Donna because he expected the real-estate market to continue to suffer for the foreseeable future, so any risky investment was (in his estimate) likely to lose additional value. The directors unanimously agreed to instruct Chloe to sell the Property immediately.

Chloe was very upset when Owen told her of the board’s decision, and complained that this decision thwarted the whole purpose of hiring her. But Owen did not relent, and finally Chloe said she would sell the Property as instructed.

Chloe diligently tried to find buyers, and the best offer she received for the Property was \$5.5M. Chloe believed the Property was worth much more than that (which is why she bought it for Prosperity in the first place). So, she contacted Ricky, a business acquaintance and wealthy investor, told him why she bought the Property for Prosperity and why Prosperity wanted to get rid of it, and persuaded him to team up with her to acquire the Property from Prosperity. They formed CR Corp. (“CR”), a Delaware corporation owned 50% by Chloe and 50% by Ricky. Chloe was CR’s CEO and Ricky was CR’s sole director. Ricky provided \$2M for his shares in CR, Chloe provided \$1M for her shares and also promised to manage CR without compensation.

Chloe then drafted an agreement selling the Property to CR for \$6M – the price Prosperity paid to acquire it, and higher than the best outside offer Chloe received. Chloe signed the agreement on behalf of Prosperity, and Ricky signed the agreement on behalf of CR. The agreement was conditioned on approval by Prosperity’s board. Since CR only had \$3M in cash from Ricky & Chloe’s contributions, CR borrowed another \$3M from a bank.

Chloe brought the agreement to Prosperity’s board, requesting that they approve it. The directors did not ask, and she did not tell them, whether other offers were sought for the Property, what they were or who owned CR. Given the market conditions, the board was very happy to dispose of the risky property without a loss, and unanimously approved the deal, which closed a few days later.

The next few months were tumultuous, with the real-estate market cycling between hope and fear. About three months after CR acquired the Property, investors were hopeful again and the price of risky real-estate soared. CR sold the Property at that point, for \$8M. Under the terms of its \$3M loan it had to pay it back, leaving CR with \$5M in cash.

CR distributed a dividend of \$4M to its shareholders, and then purchased another property for \$10M, again borrowing from the bank (this time, \$9M) and offering the new property as collateral for the new loan.

But then the market suffered a severe crash, and the value of the new property declined to \$9M. The bank lawfully foreclosed on the new property and sold it to recover its loan, leaving CR with no assets.

At this point Owen learned that CR was 50% owned by Chloe. He informed Donna and Darren, and all three directors unanimously voted to make Prosperity sue Chloe and Ricky for the transaction in which Prosperity sold the Property to CR. Among her defenses, Chloe pointed out that Prosperity did not suffer any harm – and indeed benefited – from the challenged transaction, so even if Chloe was liable (which she denied), Prosperity was not entitled to any damages as a remedy.

**Discuss Prosperity’s suit against Chloe and Ricky (including the issue of the remedy).**

## **Model answer for Fall 2013 BA1 exam:**

### **1. Suit against Chloe**

a. Authority: Yes; BoD unanimously gave Chloe express authority to sell the property.<sup>1</sup>

b. Duty: Under Rest. 1.01, Chloe is Prosperity's agent if she acts on behalf of Prosperity (she does – hired to identify and buy for Prosperity promising real-estate ventures), and subject to Prosperity's control (e.g., board's instruction to sell the Property). Therefore, Chloe is Prosperity's agent and owes FD to Prosperity (Rest. 8.01).

c. SoR: Chloe is an agent, so agency SoR applies.

d. Application

(i) No negligence – Chloe was informed & diligent in exploring sale alternatives.<sup>2</sup>

(ii) Chloe had CoI in selling the Property to CR, because as a 50% owner of CR her self-interest was to pay lowest price possible, while Prosperity's interest was to sell the Property at highest price possible. It doesn't matter whether she paid a fair price – under the Agency SoR, an agent breaches her FD whenever she acts as an adverse party (Rest. 8.03).<sup>3</sup>

(iii) In selling the Property to CR, Chloe also received an unauthorized benefit arising out of fiduciary position, violating Rest. 8.02: The benefit was \$1M (Chloe's 50% share of the \$2M profit from the Property).<sup>4</sup> It was unauthorized, despite the board's vote to

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<sup>1</sup> Some students analyzed authority to buy the Property. This is wrong since the suit challenges “the transaction in which Prosperity sold the Property to CR”. Other students argued that Chloe lacked authority because she was not authorized to self-deal (sell to a buyer she has an interest in). This confuses authority and FD: her authority to sell was not qualified by whom the buyer should be; the problem with the self-dealing is that she is potentially exercising a power that she has (selling the Property) for an improper purpose (satisfying her self-interest rather than Prosperity's interests) – this is a matter of FD.

<sup>2</sup> Some students argued that Chloe may have been negligent in forgetting to inform the board about her interest in CR. While it is more likely that Chloe was aware of her interest and self-interestedly omitting to mention it, this argument was awarded points as long as the remedy discussion mentioned that negligence (unlike benefit from fiduciary position) wouldn't result in any remedy, because Prosperity did not suffer any damages & disgorgement is unavailable for negligence.

<sup>3</sup> In buying the Property Chloe didn't violate Rest. 8.04(competing with the principal), nor did it usurp a business opportunity, because Prosperity was selling the Property, while Chloe was buying it (i.e., Prosperity was not interested in the opportunity to buy the Property). Chloe also didn't violate Rest. 8.05(2) in communicating information to Ricky, because this sharing this information with third parties was likely to advance Prosperity's interest of getting third parties to bid for the Property.

<sup>4</sup> The dividend is irrelevant to calculating the benefit – Chloe benefits as much from her share of an increase in CR's value (from profits that were not distributed as a dividend) as she does from CR's profits that are distributed a dividend. The dividend itself includes not just profits from selling the Property, but also funds previously invested in CR by Chloe & Ricky (which aren't a benefit from fiduciary position). Likewise, the benefit is not the entire \$2M profit for CR from the deal, since half of that went to Ricky, who does not owe Prosperity a FD.

Some students argued that no benefit was earned since at the time of the purchase Chloe could not know that she would profit from the Property. However, she anticipated such profits (they were the reason she created CR). The prohibition on unauthorized benefits (and the disgorgement remedy accompanying it) are designed so that it's never profitable for an agent to breach FD. If Chloe's situation isn't a benefit, it would incentivize agents to breach their FD and self-deal if they think the market currently undervalues an asset of the principal.

approve the sale, because the board approved without knowing a material fact: that Chloe owned 50% of CR (a fact that is material because it would make a reasonable director question if the price CR was paying was sufficient). Finally, the benefit was derived from the fiduciary position because the sale was conceived and negotiated by Chloe in her role as Prosperity's agent.<sup>5</sup>

Conclusion: Chloe breached her FD by self-dealing (both due to her CoI and due to deriving an unauthorized benefit).

e. Approval: BoD's approval of the sale did not approve Chloe's FD breach, because Chloe did not inform BoD of her interest in CR, so approval was uninformed.

f. Remedy: Prosperity didn't suffer harm from Chloe's breach,<sup>6</sup> but an unauthorized benefit derived from fiduciary position entitles the principal to disgorgement – receiving the benefit the agent derived. Chloe received a benefit of \$1M (see 1d(iii)), and Prosperity can recover that amount from Chloe.

## **2. Suit against Ricky**

Ricky does not owe a FD to Prosperity, since he is neither Prosperity's agent nor organ. Ricky can be liable for Chloe's FD breach in one of the following ways: (1) directly, if Ricky aided and abetted Chloe's breach; (2) indirectly, if CR is liable for Chloe's breach and the veil can be pierced to Ricky.

### **a. Direct liability**

Under *Morgan*, the elements of aiding & abetting a FD breach are:

- (i) Existence of a fiduciary relationship: Chloe owes Prosperity a FD as its agent (see 1a).
- (ii) Breach of the fiduciary's duty: Chloe breached her FD by self-dealing (see 1b&1c).
- (iii) Knowing participation in that breach by the defendant: Under *Malpiede*, defendant knowingly participates when (among other things) he and the fiduciary conspire in or agree to the FD breach. Here, Ricky knows that Chloe is Prosperity's agent (thus owing Prosperity a FD), and also knows she is using her fiduciary position to sell the Property to CR. He participates by forming CR and signing the agreement with Prosperity.
- (iv) Damages proximately caused by the breach: Prosperity did not suffer damages from the breach (see 1d(i)), but Chloe is liable for the \$1M benefit she received. Our course material didn't address whether proving an unauthorized benefit satisfies the damages prong, but the policy reason for allowing disgorgement (ensuring FD breach is never profitable to the agent) should apply to a third party's liability for aiding & abetting. So, Ricky might be liable for the \$1M benefit that Chloe derived under an aiding & abetting theory.

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<sup>5</sup> Some students argued that the benefit is not from fiduciary position because anyone could have bought the Property from Prosperity (Chloe didn't need to be Prosperity's CEO to buy the Property and profit). But Chloe likely wouldn't have learned about the property's value had she not researched it before buying it on Prosperity's behalf, so the knowledge (and resulting benefit) was derived from fiduciary position.

<sup>6</sup> Chloe was instructed to sell the Property immediately, and if CR had not bid for it, it would have been sold at \$5.5M. So, Prosperity actually gained \$500K as a result of the breach.

b. Liability via CR

(i) CR may be liable for Chloe's breach under three theories:

- (1) Aiding & abetting Chloe's breach: Same as 2a, except that CR participated in the breach by being the vehicle through which Chloe performed the self-dealing transaction. Participation was knowing because CR knows what its CEO (Chloe) and BoD (Ricky) knew – that Chloe was self-dealing.
- (2) Rest. 7.04: CR (through Ricky as CR's BoD) authorized the tortious act of buying Prosperity's Property, and therefore it is directly liable for its agent's tort.
- (3) Rest. 7.07: Chloe was an employee (CR's BoD has the right to control the manner & means of her management duties) and buying the Property was within her scope of employment under the purpose test because she purchased the Property to advance CR's interests.

(ii) PCV from CR to Ricky: Under *Sea-Land*, PCV is appropriate when –

- (1) There's such unity of interest between debtor & defendant that their separate personalities no longer exist: can be established if assets were siphoning from debtor to defendant. Here, CR distributed a dividend to Ricky (and Chloe) that amounted to 80% of its assets, including all of the profit made from selling the Property and two thirds of the money the shareholders initially invested in CR. The distribution respected formalities, but may satisfy the "unity of interest" prong if it siphons most of CR's former assets to its shareholders.
- (2) Adherence to fiction of separate corporate existence would sanction fraud or promote injustice: Prosperity's claim against CR is tortious – aiding & abetting FD breach. Thus, to satisfy the injustice prong Prosperity should show that CR was undercapitalized. Prosperity has a viable case – not only did CR reduce its capital by 80%, but it also expanded the scope of its business at the same time: when it was formed, CR's \$3M capital covered 50% of its \$6M asset. Now, the \$1M remaining as capital covers only 10% of CR's \$10M asset. This increased leverage occurred not due to business losses, but due to siphoning CR's assets (through dividend distribution). This may suffice to demonstrate that Ricky (as CR's board & co-controller) deliberately undercapitalized, leaving Prosperity unfairly unable to recoup a judgment against CR.