

## University of Illinois College of Law Examination Cover Sheet

### **Business Associations**

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Number of Pages: 4 (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 Athena Newcomb (Room 324) between 9-10am on one of the following days: December 10, 11, 12, 15.
  - b. You must submit your response as a .doc (Microsoft Word) file e-mailed to Athena Newcomb (athena@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.

Cassandra Investment Analysis, Inc. (“Cassandra”) is a public Delaware Corporation that provides investment research; that is, it provides its clients with an analysis of investment opportunities. Cassandra’s board consists of three directors. Cassandra is extremely contrarian: it frequently claims that trendy investments are over-valued and cautions its clients not to invest in them. During stock market booms, this results in Cassandra getting a bad reputation, as investments it advises against continue to rise in value and Cassandra’s clients feel they missed profitable opportunities. However, most of Cassandra’s predictions turn out to be true, so when eventually the market corrects itself (as Cassandra predicted months before), the trendy investments lose most of their value. By then, however, Cassandra tends to lose most of its clients.

As a result, Cassandra’s profitability and reputation is counter-cyclical. It does poorly when stock markets rise, but shines when stock markets collapse. Following stock market collapses Cassandra often gets offers to be acquired, but Stewart, Cassandra’s largest shareholder for the past 20 years, insisted on maintaining Cassandra independent and rejected all offers to sell his shares.

Cassandra’s reputation soared again in the aftermath of the collapse of the subprime mortgage market in 2008, which Cassandra had been warning about since early 2006. Cassandra received numerous offers to be acquired by various investment banks. The highest offer, at \$100/share, was made by Midas Money Management (“Midas”), an investment bank. Cassandra’s board opposed the offers, claiming that Cassandra’s value was in its independent views, and this independence would be threatened if Cassandra was owned by Midas or another investment bank, which would want Cassandra’s research to be favorable to the bank’s clients. Stuart agreed, and his refusal to sell his shares scuttled the offers.

With the offers rescinded and the stock market rising again, Cassandra lost much of its popularity with both customers and shareholders. It had been warning since early 2012 that social network stocks were overvalued, yet those stocks continued to rise and Cassandra’s clients felt that they were missing investment opportunities that have enriched many other investors. Cassandra’s own stock, which traded at almost \$100/share in response to Midas’ offer, was now trading at about \$50.

At this point, Stuart died. In his will he bequeathed his shares in Cassandra to over 500 charitable organizations. Those organizations, short on money and concerned about holding stock that has sharply declined in the past couple of years, sold most of their shares on the stock exchange. This further depressed Cassandra’s stock price, to about \$35/share. For the first time in Cassandra’s history, no shareholder owned more than 5% of the company’s shares.

At this point, a hedge fund called Blitz acquired 10% of Cassandra’s shares. Blitz had the opposite investment philosophy from Cassandra – it would spot a developing trend early, invest in it, and then sell to others as the investment became popular (and before the trend ended and prices collapsed). Investments in Blitz’s fund were locked-up for only 6 months (i.e., investors could pull the money out after six months), which made it very popular with investors but also required that Blitz would make profits on its investments quickly (since a strategy that would lead to a year or two of losses before it generated profits would cause fund investors to pull their money out of Blitz before the profits materialized).

Blitz announced that it will push to sell Cassandra to an interested buyer. Cassandra's board replied that Cassandra should not be sold now, while the market was doing well (and Cassandra was unpopular), but immediately following a market crash, when Cassandra is vindicated and is popular with clients. Blitz replied that Cassandra's board refused to sell to Midas under precisely such circumstances.

When it became clear that Cassandra's board would not support a sale of the company, Blitz announced that it would run a proxy contest and replace Cassandra's board with its own nominees in the next shareholder meeting. Blitz recruited three senior executives in financial companies as director candidates ("the directors"), and signed a contract that paid them \$10,000 each for standing up for election as Cassandra's directors, and committed Blitz to pay a bonus of \$5M to each of them if they are elected as directors and if they cause Cassandra to be acquired within one year for a price of at least \$50/share. Both the \$10K and the bonus would be paid by Blitz, and are unrelated to the compensation directors would get from Cassandra if they are elected (which amounts to about \$100K/year). The agreement between the directors and Blitz further stated that if elected as Cassandra directors, the directors would act on their own judgment of what is good for the company and would not give Blitz preferential treatment over other shareholders. Blitz won the proxy contest and the directors were elected to Cassandra's board, replacing the previous board members.

Cassandra's board now hired an investment bank, Weasel Brothers ("Weasel"), to actively solicit offers from interested acquirers. Weasel was paid a retainer of \$100,000, which it would receive whether or not it secured a deal. Cassandra instructed Weasel that prior to soliciting offers, Weasel should conduct a valuation of Cassandra using a particular valuation model preferred by the board, and then compare any offers it receives with that valuation to determine the fairness of the offers.

With the stock market booming, Cassandra was again unpopular with clients and no acquirers emerged. After nine months of searches, Weasel managed to renew Midas' interest, but Midas' offered only \$45/share, citing Cassandra's currently low profitability. In one meeting between Weasel's and Midas' CEOs ("the CEO meeting"), Weasel told Midas that according to their valuation, Cassandra is worth at least \$60/share under the worst assumptions, and over \$100/share under good assumptions. Midas replied that it would be unable to finance any offer above \$45/share. Weasel said that it (Weasel) would be happy to provide Midas with a loan to finance the deal. Midas's CEO asked to consult with his board, left the meeting, and returned after an hour with a final proposal: \$50/shares, which would be financed by a loan from Weasel at an interest rate that was 0.1% higher than the rate that Weasel offered ("the financing arrangement"). Midas said its offer was final and it wouldn't pay more than \$50/share. The CEO meeting concluded.

Weasel executives considered their valuation models and concluded that a few assumptions were inaccurate. Tweaking those assumptions (but still using the valuation model Cassandra's board wanted), Weasel concluded that Cassandra was worth \$40/share under bad assumptions and \$55/share under the best assumptions. They returned to Cassandra's board and presented Midas' offer and Weasel's (tweaked) valuation. They didn't mention the CEO meeting, the financing arrangement or the fact that they had an earlier, higher valuation.

Cassandra's board pushed back on Weasel's analysis, especially on whether Midas could be made to pay more than \$50/share. Eventually, though, they accepted that Midas would not offer more than \$50/share and that it was extremely unlikely that anyone else would be interested in buying Cassandra at present. They negotiated a formal acquisition agreement with Midas for \$50/share ("the deal"). The deal included a clause stating that if Midas breached the agreement and failed to buy Cassandra, it would have to pay Cassandra a termination fee of \$100M. The deal did not mention the financing arrangement and Cassandra's board was unaware of it.

Cassandra's board approved the deal unanimously and brought it to a vote at the shareholder meeting. The board reminded shareholders about the arrangement they had with Blitz, under which the directors would receive from Blitz \$5M each if the deal were approved (since the deal was reached within a year and for at least \$50/share). Over 90% of Cassandra's shareholders approved the deal.

After the shareholder approval, while the deal was pending antitrust approval, Weasel discovered a massive embezzlement by an employee. The losses brought Weasel to the verge of bankruptcy, and it had to fire many employees to cut costs. Delphine, a former senior Weasel employee who was fired, told the media about the negotiations between Weasel and Midas (including the CEO meeting). When these details surfaced, Scott, a Cassandra shareholder, sued Midas and Weasel derivatively (i.e., sued them on behalf of Cassandra) for recommending the deal to Cassandra's board. [Assume Scott has standing to sue on Cassandra's behalf and don't address this in your answer.]

Before Scott's suit was litigated, Midas contacted Cassandra's board and told the directors that if they didn't ratify Weasel's behavior to thwart Scott's suit, Midas would walk away from the deal, even if this meant breaching it. They informed the board of all the details of Midas' negotiations with Weasel, including the financing arrangement.

Cassandra's board met and ratified Weasel's recommendation of the deal and the financing arrangement, with full knowledge of Weasel's dealings with Midas. Cassandra's board then petitioned the court to dismiss Scott's suit, claiming that any flaw in Weasel's or Midas' conduct was corrected by the ratification.

Meanwhile, Weasel was litigating an unrelated suit by Vicky. Vicky was a pedestrian hit by a car driven by Ian, an undergraduate student interning at Weasel. A few months earlier, Ian was sent by Delphine to deliver to Midas some documents regarding Cassandra, which Midas needed in order to decide whether to buy Cassandra. Just before Ian left, he and Delphine spoke on the phone with Cassandra's CEO, who was anxious to get this information to Midas to get Midas interested in bidding for Cassandra. The CEO said: "I don't care what it takes, Delphine, this needs to be in their hands right away." Delphine turned to Ian and said: "You heard our client, Ian. I want this at Midas' office yesterday." Ian subsequently drove recklessly, lost control of the car when he turned a corner and hit Vicky, who was walking on the sidewalk. The trial on Vicky's suit had just concluded, with Weasel found directly liable for authorizing the reckless driving that caused Vicky's injuries. However, Weasel's financial situation meant Vicky was unlikely to collect much of the judgment. Vicky motioned for, and the judge approved, adding a claim against Cassandra for Vicky's injury from the car accident. **Discuss Scott's suit, and Vicky's claim against Cassandra.**

## **Model answer for Fall 2014 BA exam:<sup>1</sup>**

### **1. Scott's suit against Weasel**

a. Flaws: Weasel was expressly authorized to recommend a deal to Cassandra's board.<sup>2</sup> However, it breached the FD it owed as Cassandra's agent by self-dealing (indeed, taking an outright bribe) – recommending the deal in order to finance it, which raises CoI and unauthorized benefit concerns.

b. Duty: Under Rest. 1.01, Weasel is Cassandra's agent if it acts on behalf of Cassandra (it does – hired to solicit offers from interested acquirers), and subject to Cassandra's control (e.g., using board's preferred valuation model). Therefore, Weasel is Cassandra's agent and owes FD to Cassandra (Rest. 8.01).

c. SoR: Weasel is an agent, so agency SoR applies to the self-dealing flaw.

d. Application: Weasel had CoI with respect to advising on the deal: Cassandra only wanted the deal if the price is fair, but Weasel wanted the deal at any price to profit from financing it.<sup>3</sup>

In addition, Weasel received an unauthorized benefit arising out of fiduciary position, violating Rest. 8.02: The benefit is the profit on financing the deal (we don't know how much it is, but whatever rate Weasel requested was presumably profitable, and Midas agreed to pay 0.1% more).<sup>4</sup> The benefit was unauthorized because Weasel did not inform the board about its role financing the deal. Finally, the benefit was derived from the fiduciary position: Midas offered Weasel sweet terms to finance the deal because Weasel was in position to influence Cassandra's response to the offer through its role as advisor (similar to *Reading*). Self-dealing (whether CoI or unauthorized benefit) automatically breaches FD under agency SoR.

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<sup>1</sup> The exam fact pattern combined elements from several recent events. See: Alexandra Scaggs, *With buyout, ISI faces day of reckoning*, WSJ (8.26.14), p. C3 (the situation of an independent research firm considering being acquired by an investment bank); David Benoit & Joann S. Lublin, *Thorny pay point arises in Dow feud*, WSJ (11/17/14), p. C3 (potential CoI of Dow Chemical directors who have a side agreement hedge fund Third Point that would reward them for short-term performance); Liz Hoffman, *RBC hit with damages in suit*, WSJ (10/13/14), p. C3 (suit against an M&A adviser for seller that also lobbied acquirer to finance the deal, and modified its valuation to make a lower offer appear appealing).

<sup>2</sup> It was wrong to discuss Weasel's authority to make the loan, since Weasel did not purport to make the loan on behalf of Cassandra (it was making it on behalf of itself). Also, it was wrong to discuss Weasel's apparent authority, since Scott's suit regards the internal relationship between a principal and its agent, not the external relationship with a third party. A discussion of Weasel's actual authority to negotiate the deal was relevant only to the extent that it considered whether Weasel is liable for exceeding authority. Students who discussed actual authority together with apparent authority demonstrated that they misunderstood the role of authority here.

<sup>3</sup> The conflict of interest exists even if Weasel did not intentionally modify Cassandra's valuation to cause the board to accept Midas' offer. While intentional misevaluation would certainly breach FD, it's enough that Weasel has a conflicting interest (profit from the loan), even without acting in pursuit of this interest.

<sup>4</sup> Even if the deal did not close yet (so Weasel may not have received any interest payments yet), Weasel has a contractual right to lend the money at an advantageous interest rate, which is a benefit.

e. Approval: Cassandra's board unambiguously ratified Weasel's actions,<sup>5</sup> but it was an inappropriate approver because all three directors were conflicted:<sup>6</sup> if they refused to ratify Midas would breach the deal, which would result in the directors losing their \$5M bonus. Therefore, the ratification fails.<sup>7</sup>

## 2. Scott's suit against Midas

Midas does not owe a FD to Cassandra, since it is neither Cassandra's agent nor organ. Midas can be liable for Weasel's FD breach if it aided and abetted Weasel's breach.<sup>8</sup> Under *Morgan*, the elements of aiding & abetting a FD breach are:

- (i) Existence of a fiduciary relationship: Weasel owes Cassandra a FD as its agent (see 1b).
- (ii) Breach of the fiduciary's duty: Weasel breached its FD by self-dealing (see 1d), and that self-dealing was not ratified (see 1e).
- (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. Midas knows that Weasel is Cassandra's agent (thus owing Cassandra a FD that would be breached by self-dealing), and participates by offering Weasel a financing arrangement that amounts to a bribe: financing the deal on more generous terms than Weasel offered, tied to an acquisition price that is bad for Cassandra (\$50/share rather than the minimum of \$60 that Weasel suggested).
- (iv) Damages proximately caused by the breach: The recommendation proximately caused Cassandra's board to approve the deal. Damages are equal to the value of Cassandra, minus the purchase price of \$50/share. Assuming Weasel's original valuation was correct, Cassandra is worth between \$60-\$100/share, damages are \$10-\$50/share.

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<sup>5</sup> Earlier board and shareholder approvals of the deal were not potential approvals of the FD breach, because at the time of these approvals, neither the board nor the shareholders even knew there was a possible FD breach, so they couldn't have ratified it (and the votes were explicitly authorizations of the deal, not a ratification of any sort).

<sup>6</sup> Some students claimed that the board was an inappropriate approver because the shareholders needed to approve (since the matter related to a sale of the company). This is incorrect because it mistakes what needs to be approved – self-dealing by the agent, not authority to conduct the deal itself (the latter was already approved). Self-dealing by the firm's agent can be ratified by the board.

<sup>7</sup> There was no taint of duress in the ratification – Midas had no leverage against Cassandra (it could breach the agreement but then suffer the legal consequences of the termination fee). Likewise, this was not a ratification to avoid a loss – a loss requires that but for the ratification, the principal would be worse off than had the transaction never been negotiated by the agent. If a loss included losing benefits of the deal negotiated by the agent, every ratification would be to avoid a loss, since any time P ratifies, it indicates P thinks it's better off with the deal than without it.

<sup>8</sup> Some students argues for Midas liability for aiding & abetting FD breach by Cassandra's board (basically, that Midas priced its offer at \$50 knowing that the directors had a personal interest to sell the company within three months for at least \$50 (while the firm would have preferred to wait longer than three months if that meant getting a better price). This was not among the issues you were required to discuss because I thought this argument was more tenuous than aiding and abetting Weasel's breach (first, because the latter breaches FD even if the deal was fair, and second because it's unclear whether Midas knew about the Cassandra directors' deal with Blitz, and without this knowledge Midas did not knowingly participate), and discussing it would have required spending a lot of words on analyzing a minor issue. Still, students who made this argument earned extra-credit points if fully discussed, including a fairness assessment of the deal (because the board actions, unlike Weasel's, are the acts of an organ) and including a connection between the board FD analysis and Midas' aiding and abetting claim. However, more points were earned for making the more straightforward argument for aiding & abetting Weasel's FD breach (discussing both issues perfectly would have earned full points for this issue, plus extra-credit points).

### **3. Vicky's suit against Cassandra**

Weasel is Cassandra's agent (see 1b), so Cassandra may be liable for Weasel's tort via:

- (a) Actual authority: the tort would be authorized under Rest. 2.01, if Cassandra's manifestation to Weasel ("I don't care what it takes") caused Weasel to reasonably believe that reckless driving was authorized. Delphine's similar manifestation to Ian was seen as such authorization. But Delphine was speaking to a young intern while Cassandra's CEO was speaking to Delphine, who is experienced and presumably less excitable. Furthermore, Delphine increased the sense of urgency (delivering the documents "yesterday" rather than "right away"). These are small differences, but they may be enough that Delphine could not reasonably believe Cassandra's CEO authorized her to drive recklessly. So no liability due to actual authority.
- (b) Respondeat superior: Weasel is probably an employee of Cassandra, because Cassandra controls "the manner and means of the agent's performance of work" (Rest. 7.07(3)(a)) – Cassandra specifically instructs Weasel what valuation method to use, and what documents must be delivered promptly (the latter is borderline between control of results and control of physical conduct). Weasel's driving of the car was within its SoE: it was "performing work assigned by the employer" (Rest. 7.07(2)), and the recklessness driving was intended to serve Cassandra's purpose of getting the documents to Midas quickly. Therefore, Cassandra is liable to Vicky under respondeat superior.