

University of Illinois College of Law Examination Cover Sheet

Business Associations

Professor Amitai Aviram

Fall Semester 2023

Number of Pages: 4 (including this page)

Exam Date & Time: Wednesday, Dec. 6, 9am.

Exam Instructions

1. **Accessing and submitting the exam**
 - a. The exam form will be e-mailed to you by my administrative assistant, on the Exam Date & Time.
 - b. Save your exam answer as a Word (.doc or .docx) file, with the file name being your 4-digit exam number.
 - c. **Submit the exam within 6 hours of the Exam Time (e.g., before 3pm if the Exam Time is 9am)**, by e-mailing it as an attachment to my administrative assistant Kelly Downs (kdwns@illinois.edu).
2. **Permissible material:** This is an open book exam. Subject to Instruction 3 (confidentiality), you may use any written materials you want, whether in hardcopy or electronic format.
3. **Confidentiality:** 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. Students enrolled in this course are not allowed to solicit or receive information about the exam if the source of the information (directly or indirectly) is a person who has seen the exam.
4. **Anonymity:** The exams are graded anonymously. Do not put in your exam answer anything that may identify you, except for your 4-digit exam number.
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), 1 point will be taken off the exam's raw score.
6. **Answering the exam:** Cite relevant case and statutory authority that is part of the course material, but do not cite sources that are not part of the course material. 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, UPA, and U.S. securities law.
 - b. Each business entity's charter states that: the entity is a stock corporation, has limited liability and perpetual existence; the entity may conduct any lawful act or activity; director fiduciary duty is limited to & director/agent right to indemnification is extended to the maximum degree allowed under DGCL §102(b)(7); the board may amend the bylaws.
 - c. Each business entity's bylaws state that: the chairperson of the board is authorized to call a board meeting; and the board is authorized to call both annual & special shareholder meetings.
8. **"Fact" patterns are fiction:** The "facts" presented in this exam are not necessarily true in real life.

Ever since his college days, Sal was concerned about incivility and harassment on social media. Later, as he studied for a graduate degree in artificial intelligence, he formed a student association aimed at fostering civility on the internet. An interview with a local newspaper brought him to the attention of Vivian, a venture capitalist, and Dana, a computer science professor who specialized in cyber-ethics. With a donation from Vivian, the three formed the Responsible Internet Foundation (“RIF”), a nonprofit association.

Sal believed that human administrators could not monitor the vast amount of content created on social media to adequately identify and remove hate speech and cyber-bullying. Sal’s vision was to create a computer program he called Tolerance that, using artificial intelligence, would identify and remove abusive content thousands of times faster than human beings could. RIF was formed to facilitate this vision.

RIF hired a team of programmers and under Sal’s direction they created Tolerance. Since Tolerance relied on artificial intelligence, the program would need to “train” itself on a lot of data, while the programmers tweaked it to improve its performance.

Very soon it became apparent that this AI-training would require enormous computing power, costing tens of millions of dollars and perhaps more. The donations RIF received were not nearly sufficient to cover these costs. After studying the problem thoroughly, RIF’s board concluded that the only way to raise the amount of money they needed was to shift the development of Tolerance to a for-profit corporation, and then sell shares in that corporation to investors.

Vivian’s connections in the tech industry proved useful in lining up investors. She incorporated the Responsible Internet Corporation (“RIC”), a Delaware corporation. 51% of RIC’s shares were sold to Microsoft, a giant tech company. The remaining shares were sold to 25 smaller tech investors. Originally, RIC’s board consisted of five directors: Sal, Vivian and Dana, as well as Mike (a Microsoft employee) and Helen (a tech blogger and activist against cyber-bullying). RIF assigned to RIC all the rights to Tolerance, and all of the people who worked on Tolerance left RIF and became employees of RIC. Sal became RIC’s CEO.

The developers of Tolerance could now afford all the computing power the program needed, and it developed nicely: it could identify abusive content tens of thousands of times faster than humans could, and many internet platforms expressed an interest in licensing Tolerance.

Perhaps it was too effective, though. Based on reports from RIC employees, Helen expressed concern that Tolerance was tagging too much content as abusive and removing it. The developers wanted to avoid the embarrassment of Tolerance failing to identify a really bad post, and thus preferred to err on the side of over-censoring.

The board discussed Helen’s concern, but Sal, Vivian and Mike were adamant that Tolerance had to “be aggressive” because its reputation would be destroyed if it was publicly seen to miss an extremely abusive post. Dana was noncommittal, and the board allowed Sal to proceed with Tolerance’s development without changes.

In the following months, RIC began to sell licenses to use Tolerance, and customers were very happy. Social media platforms and other companies relied on the software instead of having their employees monitor their websites for abusive content, and this was not only much cheaper, but also much more effective, as the AI could catch abuses much faster than humans had. RIC was earning a lot of money. Other tech companies realized how profitable Tolerance’s business niche was and started to develop rival products.

Vivian's venture capital firm was an investor in one of these new rivals. Vivian said that she could not remain a RIC director now that she was affiliated with a competing venture, so she tendered her resignation from RIC's board. Meanwhile, antitrust regulators were unhappy about Microsoft's potential influence on RIC. To assuage their concerns, Microsoft agreed not to have any representation on RIC's board. Mike tendered his resignation as well, and RIC's board downsized to 3 directors: Sal, Dana and Helen.

Despite the appearance of competition, Tolerance's AI enjoyed the competitive advantage of being trained much longer than its newly developed rivals, and sales of licenses continued to rise. RIC's profits likewise soared. Helen, however, was troubled by another report from RIC employees, which said that Tolerance is more aggressive in tagging as abusive content that is of concern to advertisers (i.e., content that is offensive to more affluent customers that advertisers target) than content that is offensive to other groups (such as less affluent people who buy less and are therefore of less interest to advertisers) (the "Tolerance Bias").

Sal explained that the Tolerance Bias was a feature, not a bug. Tolerance's customers were internet platforms, and their main concern was to assure advertisers that their ads would not be seen next to offensive content. So naturally Tolerance is optimized to identify and remove the content that its customers are concerned with.

Helen responded that such a viewpoint-based bias was unethical and possibly illegal. Dana suggested that they check if the Tolerance Bias violated any laws, and Sal agreed. They hired a reputable law firm to advise them. At the next board meeting they reviewed the law firm's legal opinion, which after thorough investigation and analysis found that RIC would not violate any laws or be exposed to any legal liability from the Tolerance Bias.

Helen said that even though the Tolerance Bias is not illegal, it is immoral and must be stopped. To Sal's surprise, Dana said she agreed. Sal was apoplectic: "This is what our customers want, and it is legal. We are facing increasing competition and if we remove the Tolerance Bias, advertisers will complain, and customers will switch to another product. RIC could be out of business within weeks."

"I'd rather have RIC go out of business than sell an unethical product," replied Helen.

"What will you tell our shareholders?" asked Sal.

"I'll tell them that they already made an amazing return on their investment with the profits we made so far," Helen said, "and I'll tell them that as long as I'm on the board of RIC, the company will put ethics above everything else – even above the company's survival." Dana nodded.

The board voted 2-1 to instruct the employees to remove the Tolerance Bias from the software (the "Board Decision"). Sal then announced his resignation both as director and as CEO.

When RIC's employees and shareholders heard of the board decision and Sal's resignation, many of them bombarded the board with demands to reverse the decision and bring Sal back. Dana and Helen called Satya (Microsoft's CEO). The directors fully explained the situation and asked Microsoft to back their decision. Satya told them he would not have made the decision they made, but it was not for him to judge their ethical position. He agreed that Microsoft would ratify the board's decision. Microsoft's board then signed a document titled "shareholder consent", which purported to ratify the Board Decision and delivered it to RIC's board.

Sal now called Satya, and told him that most of RIC's employees are furious at the board and that he (Sal) and many other members of the Tolerance development team would be happy to work for Microsoft in creating a product like Tolerance. Satya hired Sal to work for Microsoft, and agreed to hire any other members of the Tolerance team who would like to leave RIC and join Microsoft. Sal and his team were instructed to develop a product like Tolerance, as long as they did not infringe on RIC's intellectual property.

Sal busied himself with developing a new product from scratch, but he burned with anger about being pushed out of the company that he founded. Using a computer in his Microsoft office, he connected to RIC's network. That network was password-protected, but Sal was able to enter using his old password from when he was RIC's CEO (RIC didn't remove his account from the system yet). He then placed a computer virus in RIC's computer system, which went through the system and destroyed any files related to Tolerance. Since Sal used to be RIC's CEO, his account had access to all the backup servers, so the virus was able to destroy Tolerance completely. You may assume that Sal is liable to RIC in torts for destroying Tolerance.

RIC sued Microsoft for the harm caused to RIC by Sal's insertion of a virus that destroyed Tolerance. Patrick, one of RIC's shareholders, sued RIC's board for the harm caused to RIC by the Board Decision. Among other arguments, Patrick alleged that a reasonable director would have taken more time and sought more information before deciding to remove the Tolerance Bias, given the CEO's warning that doing this could cause RIC to be out of business within weeks. RIC's board did not contest this (so you may assume Patrick's allegation is true), nor did it challenge Patrick's standing to sue (so do not discuss standing issues).

Discuss RIC's suit and Patrick's suit.

Model answer for the Fall 2023 BA exam

1. RIC's suit:

- (a) Actual Authority: Sal is Microsoft's agent under R3A§1.01, because Sal acts on Microsoft's behalf in developing software, and is subject to Microsoft's control (e.g., not infringing RIC's IP). Satya instructed Sal "to develop a product like Tolerance". Sal has authority if this manifestation made him reasonably believe he's authorized to destroy Tolerance on Microsoft's behalf (R3A§2.01). Such belief isn't reasonable. Sal lacks authority under R3A§2.02(1) because hacking RIC's system isn't "necessary or incidental" to the agency's objectives (developing a product like Tolerance). Therefore, Microsoft isn't liable under R3A§7.04.
- (b) Apparent authority: A principal is vicariously liable "for a tort committed by an agent... when actions taken by the agent with apparent authority constitute the tort..." (R3A§7.08). If Sal were allowed to access RIC's network because he was using Microsoft's computer, he'd commit the tort with (Microsoft's) apparent authority. However, he could access RIC's network only because he had a password that identified him to the network as RIC's CEO. So Sal used apparent authority, but it was apparent authority to act on RIC's behalf, not on Microsoft's behalf. His apparent authority to act on Microsoft's behalf was irrelevant to hacking RIC's network.¹ Thus, the tort wasn't done with (Microsoft's) apparent authority, and Microsoft isn't liable under R3A§7.08.
- (c) Respondeat Superior: Microsoft is liable if Sal was its employee and destroying Tolerance was within his SoE.

Employee: Sal is Microsoft's employee if he acts on Microsoft's behalf, and Microsoft "has the right to control the manner and means of the agent's performance of work" (R3A§7.07(3)(a)). Sal develops a product on Microsoft's behalf. Absent contrary manifestations, a team manager in a Tech company must follow their boss' instructions on how to do their work. So, Sal is an employee.²

SoE: Hacking RIC's network was within SoE under the control test of R3A§7.07(2) because, while not assigned by Microsoft, it was "in a course of conduct subject to the employer's control", since Microsoft would have the right to control employee use of its computers (including prohibiting using them for hacking).³ Under the purpose

¹ Some students demonstrated that Sal might have had apparent authority from Microsoft to place a virus (i.e., that RIC could reasonably believe that Microsoft would want its employees to destroy Tolerance). But this misses the point that even if apparent authority exists, that authority needs to be used in the tort in order to impose liability of the beneficiary. For example, if RIC allowed Sal access to its network (access which Sal then used to place a virus) only because RIC believed Sal was accessing the network on Microsoft's behalf – which could have happened if, for example, RIC and Microsoft were working jointly on a project that required giving Microsoft employees access to data on RIC's system. But this was not the case here; rather, it was the perception that Sal acted on RIC's behalf (evidenced by Sal's use of his old password) that made RIC allow him to access its network.

² The answer to this issue was minimal in order to keep within word limits. Students who correctly applied relevant side tests (from *Brooks*) received additional credit for the quality of their answer.

³ Some students confused the control test for SoE with the test for employee status. These are separate tests, looking at different things. Control in the context of the employee test looks at the employment

test of R3A§7.07(2) Sal’s purpose was personal, motivated by “anger about being pushed out of the company that he founded”. However, if the court follows *Manning’s* logic, they may find that Sal’s purpose was to assist Microsoft by destroying a rival product to the one Sal is developing for Microsoft – placing his action within SoE (and making Microsoft liable to RIC under R3A§7.07. Otherwise, Sal’s hacking was outside his SoE (and Microsoft isn’t liable) since caselaw tends to follow the purpose test when it conflicts with the control test.

- (d) Negligence: R3A §7.05(1) & R3T §41(b)(3) impose on an employer a DoC towards third parties regarding risks posed by their employee, when the employment facilitates the employee's causing harm to the third party. Sal used Microsoft equipment to hack RIC’s network. However, to “facilitate”, the employment must cause the employee to pose a greater threat than from the general public. Here, Sal’s status as a Microsoft employee and his access to Microsoft’s computers don’t facilitate a greater threat of hacking RIC’s network than the general public – anyone with internet access presents the same threat. So Microsoft doesn’t owe a DoC to RIC for Sal’s hack. Even if it did owe a duty, there’s no evidence of breach: no “red flag” that would cause a reasonable employer to better supervise Sal in a way that would have prevented him from hacking RIC’s network.

2. Patrick’s suit:

RIC’s board had authority to order removal of the Tolerance Bias under DGCL 141(a), as it’s within “the business and affairs” of RIC. As for FD breach:

- (a) Duty: Defendants owe FD to RIC as directors.
- (b) SoR: BJR applies since the directors aren’t self-dealing,⁴ deploying corporate power against the SHs, or embarking on a transaction that would result in CoC.
- (c) Application – Negligence: RIC concedes board negligence, but liability is exculpated under DGCL §102(b)(7) because: exam instructions assume an exculpation clause in RIC’s charter; defendants are directors; the negligence is unintentional (intentional negligence is bad faith, analyzed in 2(d)); and Patrick sues for monetary damages.⁵
- (d) Application – Bad Faith: No conscious illegality, but the Board Decision is likely corporate waste. The facts are like *Dodge* (indeed, more extreme, since RIC’s survival, rather than just dividend payment, is at stake). The directors don’t claim that ethical concerns would be in SHs’ interests in the long run, but rather that SHs’ have “already made an amazing return” and thus ethical concerns justify RIC going out of business. If the court concludes defendants believed the Board Decision isn’t in the interest of SHs, then defendants breached FD. On the other hand, ALI’s Principles of Corporate Governance §2.01 allows directors to “take into account

relationship generally; control in the context of SoE looks at the degree of control the employer had specifically on the employee’s behavior that caused the tort.

⁴ Some students mistakenly argued that Helen (and perhaps Dana) is conflicted because she prefers her ethical views over the shareholders’ profits. This is wrong because Helen does not gain a personal benefit from RIC acting ethically. Rather, Helen believes that acting ethically is good for the shareholders and the company (even if it prevents future profits).

⁵ There was no need to analyze whether the directors were negligent, since that was conceded.

ethical considerations that are reasonably regarded as appropriate to the responsible conduct of business” even if “SH gain [isn’t] thereby enhanced”, which may permit the Board Decision.

- (e) Written consent – Validity: DGCL §228 considers a SH written consent valid if signed by “[SHs] having not less than the minimum number of votes that would be necessary to authorize or take such action at a meeting at which all shares entitled to vote thereon were present and voted”. Ratification requires default support (majority of shares present), so if all shares were present at a meeting, support of 50% plus one share is required. Microsoft owns 51% of shares, so the consent is valid.⁶
- (f) Written consent – Effect: Under *Corwin*, approval of action by an informed, uncoerced vote of disinterested SHs causes BJR to apply. Microsoft’s consent was informed and uncoerced (the directors “fully explained the situation”) and all SHs are disinterested as to the Board Decision. However, under BJR, FD is breached by corporate waste (i.e., SH ratification cannot cure corporate waste). So, if the Board Decision amounted to corporate waste (see 2(d)), the consent, while valid, didn’t cure the FD breach.

⁶ DGCL §144(a)(2) and §204 are not relevant here. Section 144(a)(2) deals with ratification of a director’s self-dealing, and Section 204 deals with ratification of lack of authority – and the board is guilty of neither of these. Thus, ratification by Microsoft cannot rely on either of these sections, and instead relies on the common law of ratification (which is governed by the rules set in R3A, though R3A does not apply directly here since this is a ratification of directors’ behavior, whereas R3A directly governs ratification of an agent’s behavior).