University of Illinois College of Law
Examination Cover Sheet

Business Associations
Professor Amitai Aviram
Fall Semester 2024
Number of Pages: 5 (including this page)
Exam Date & Time: Thursday, Dec. 12, 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 **Answering the exam**: Cite relevant case and statutory authority that is part of the course material, but do not cite sources that are not part of the course material.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.

Claire created **School Spirit Corp. ("Spirit")**, a Delaware corporation, to pursue a simple business model: contract with educational institutions like colleges and universities to operate their online bookstores. This plan looked promising, yet year after year Spirit failed to turn a profit. Claire bridged the company's annual cash shortfall by raising funds from friends and family. In return, those investors received shares in Spirit.

Despite the setbacks, Claire was certain that Spirit's business model could become profitable. Many of Spirit's expenses were fixed – that is, they had to be spent whether Spirit operated the bookstore of one university or 100 universities. On the other hand, the revenues grew with every university that worked with Spirit. So, profitability was simply a matter of obtaining scale: once enough universities worked with Spirit, the company would be highly profitable. But recruiting universities required big investments in infrastructure and generous terms to the universities – which meant that Spirit needed to raise a lot more money.

After a long search for a big investor, Claire accepted an offer by a venture capital fund called the **Vicious Vulture Fund ("Vulture")**. Vulture agreed to invest a large amount of money in Spirit, but in return it insisted on receiving a liquidation preference over the other shareholders. To facilitate this, Spirit changed its charter so that all existing shares were classified as common shares, and a new class of shares was created called preferred shares. Each preferred share had one vote (same as a common share) and had a liquidation preference of $1,000, meaning that if the company was "liquidated" (i.e., was sold or went bankrupt), each preferred share was entitled to receive $1,000 from the money available to shareholders, before the common shareholders received anything. Beyond the liquidation preference, the preferred shares were participating, meaning that any additional money left for shareholders in liquidation (after preferred shareholders received the liquidation preference) would be shared equally between all shares (both common and preferred).

Profits remained elusive for Spirit, and the attempt to scale up operations cost the company ever more money. As it ran out of money, it had to tap Vulture again for more money in return for more preferred shares. After this investment, Vulture held 60% of the votes in Spirit (the common shareholders, collectively, held the remaining 40%), and Vulture's liquidation preference amounted to a total of $30M.

Vulture used its voting power to replace Spirit's board, which consisted of three directors. Vulture kept Claire as a director, but added to the board **Pam** and **Pete**, each of whom owned 50% of Vulture. The board then voted 2 to 1 to fire Claire as CEO and offer the position of CEO to **Olivia**, an experienced executive with no affiliation to Vulture or any of the three directors.

Olivia negotiated an employment agreement that included a clause stating that if there was a change of control in Spirit (i.e., Spirit was sold to someone), Olivia would get an "exit bonus" of $1M. This clause would expire after two years. Olivia's employment agreement had to be publicly filed, and so its contents were known to the public.

Olivia believed that Spirit cared too much about revenue growth and not enough about profitability. She focused on cutting costs and centralizing Spirit's operations, standardizing the activities of the teams of employees that worked with each university.

She created an employee manual that included clearer delineation of the authority of various employees. Among other things, the employee manual said that only the board had the authority to agree to any settlement of litigation to which Spirit was a party. All Spirit employees knew the contents of the employee manual.

After a year and a half, Olivia managed to stop Spirit's losses, and the now much leaner company was earning a small profit, but its revenue growth slowed down significantly. Claire argued forcefully against Olivia's strategy, claiming that the value of start-ups such as Spirit came primarily from its growth prospects rather than profitability, so Spirit should raise more money and pursue aggressive growth. Olivia responded that if Spirit pursued growth, it would run large losses in the near future, and it didn't have enough cash to sustain these losses. Pursuing growth required raising more money, and Vulture was not interested in investing more money in Spirit. Indeed, it was considering exiting its investment.

The board discussed whether Spirit should sell itself. They instructed Olivia to seek investors interested in buying Spirit. Olivia was allowed to negotiate with investors to get the best offer, but any agreement would be subject to the approval of the board. She was allowed to hire advisors as needed.

Olivia hired investment bankers who sought buyers for Spirit. The results were very disappointing. Only two investors showed any interest, and the higher of the two offers was for $30M, which was much less than Olivia expected.

Olivia reported these developments at the board's next meeting, and said that she would make a few changes to the terms Spirit was offering universities, that would lower Spirit's profits to almost zero, but would increase revenue growth. She hoped that with a bit more growth, Spirit could get a better valuation from potential investors. The board unanimously approved her plan.

Five months later, Spirit's revenue grew slightly and profits dropped slightly, as Olivia planned. She hired investment bankers again to seek buyers for Spirit. They returned with bad news. Only one investor was now interested in bidding: a private equity fund called **Cheapskate**. Cheapskate now offered only $25M, claiming that the economic outlook for operating online bookstores has become less attractive, and if Spirit was unwilling to sell itself now, Cheapskate might not be interested in buying it later at any price.

Olivia informed the board about Cheapskate's offer. Claire said that Spirit should not be sold for any price below $30M, since that would be below the liquidation preference, so common shareholders would get nothing. Instead, Claire said that Spirit needed to pursue more aggressive growth even if that meant, in the short term, big losses. Claire was certain that if Spirit showed very high revenue growth, it would attract more investors at a higher valuation. She calculated that at the expected loss rate, Spirit could pursue this growth strategy for another year before it needed to raise more cash.

Pam noted that if Spirit followed Claire's plan and did not find a buyer at a higher valuation, then after a year it would run out of cash and into bankruptcy. Right now the preferred shareholders were being offered $25M for their shares. If the company goes bankrupt, they might get zero.

Claire replied that under Cheapskate's offer, common shareholders are certain to get zero. The board voted 2-1 (Claire voting against) to have Olivia negotiate a deal with Cheapskate, subject to the board's approval.

When Olivia met with **Charlie** (Cheapskate's CEO), he said that they have to lower their offer further, to $20M. Olivia was furious about Cheapskate withdrawing its earlier, higher offer, but Charlie told Olivia that Spirit's prospects were worsening, and they better accept his offer by the end of that month, or he would withdraw the offer and Spirit would have no options at all.

Charlie told Olivia that while Spirit's prospects were grim, he thought she made the most of a bad situation in managing the company. He told her that, should Spirit be sold to Cheapskate, they would like to retain her as the CEO. Charlie then handed her a contract (**the "Side Agreement"**) that made a legally binding promise by Cheapskate that, if Spirit is sold to them by the end of that month, Olivia will be retained as CEO with the same terms as she receives now, plus a signing bonus of $500,000.

Olivia and Charlie negotiated the details of the deal in which Cheapskate acquired Spirit for $20M (**the "Sale Agreement"**). The Sale Agreement stated that it was subject to approval by Spirit's board. It allowed Spirit to "shop" for a better offer for 60 days, and within that period, if Spirit's board have a better offer or Spirit's SHs rejected the deal, Spirit could terminate the agreement for a fee of $400,000 (2% of the value of Spirit).

At Spirit's next board meeting, Olivia showed the board the Sale Agreement and the Side Agreement. Claire said Cheapskate was pressuring them into a sale at an unfairly low price. She argued that Spirit should reject this deal, operate for a few more months and hope that better offers materialize. The current offer, she claimed, robs the common shareholders of their entire investment, since they would get nothing.

Olivia said that Spirit's valuation keeps dropping, and they should take the one offer that's available before it vanishes. Claire wondered aloud whether Olivia was so eager to sell rather than wait because a sale now would trigger her exit bonus, which would expire at the end of that month. Or perhaps, Claire suggested, it was the signing bonus Olivia would get from Cheapskate if the sale proceeded. "The CEO gets bonuses, the preferred shareholder gets $20M, and the common shareholders get nothing" lamented Claire.

Pete said that the common shareholders get nothing because the company did not achieve a valuation that's above the liquidation preference. "That's a business risk the shareholders knew they were taking. Spirit lost a lot of value and if we don't sell now, we will lose even more." The board approved the Sale Agreement on a vote of 2 to 1 (Claire voting against). The board brought the Sale Agreement to a shareholder vote (as required by law), and shareholders approved the Sale Agreement by 60% (all of the preferred shares, voted by Vulture) in favor to 40% (all of the common shares) against.

The deal closed and Cheapskate acquired Spirit (Spirit continued to exist as a corporation, now 100% owned by Cheapskate). **Carl** (a former Spirit common shareholder who is not a Spirit employee), sued Spirit's board, claiming the directors breached their fiduciary duty by approving the Sale Agreement at an unfairly low price that resulted in common shareholders getting nothing (**the "Sale Suit"**). Carl conceded that the board was not negligent in making its decision. Carl presented a valuation of

Spirit (by an expert he hired) that claimed that if Spirit continued operating, and under certain assumptions about how the market would develop in the coming year, Spirit could have a fair value of $35M by the end of the following year.

Carl also sued Cheapskate, claiming that Cheapskate aided & abetted breaches of fiduciary duty owed to Spirit's shareholders (**the "Abetting Suit"**).

Lou, Spirit's General Counsel, asked Carl to meet with him in his office at Spirit's headquarters, to discuss his suit. Lou initially tried to persuade Carl to drop the Sale Suit, but when Carl refused, Lou offered that they settle the suit: Spirit would pay the (former) common shareholders $1M, and in return they would waive any claims they had against Spirit's board, and withdraw the Sale Suit. Carl agreed, Lou wrote this into a formal agreement (the "Settlement") and they both signed the Settlement.

When Lou reported to Spirit's board about the Settlement, they rejected it, claiming that Carl has no case against either Spirit or Cheapskate, so Spirit will not pay anything to settle the suit.

When Carl found out Spirit was not paying the $1M, he sued Spirit to enforce the Settlement and require Spirit to pay the common shareholders $1M as the Settlement requires (**the "Settlement Suit"**).

Discuss the Settlement Suit, the Sale Suit and the Abetting Suit. Carl's standing in all suits is conceded (so don't discuss it). Discuss the Sale Suit even if you determine that the Settlement is enforceable.

Model answer for the Fall 2024 BA exam

1. Settlement Suit:[1]

(a) Actual Authority: Lou is Spirit's agent under R3A§1.01, because Lou acts on Spirit's behalf in legal representation, and is subject to the control of Spirit's CEO, Board and employee manual.[2] Lou is aware of the employee manual's rule that "only the board had the authority to agree to any settlement of litigation", and cannot reasonably believe this gives him authority to settle the Sale Suit. Therefore, he has no actual authority to settle under R3A§2.01.

(b) Apparent authority: Under R3A§3.03, Spirit is bound by the Settlement if Lou had apparent authority to settle, which he would if Spirit's manifestations to Carl make Carl reasonably believe Lou is authorized. Carl has one manifestation from Spirit: Lou operates in the headquarters office of the General Counsel (Carl doesn't know of the employee manual rule). Can Carl reasonably believe the General Counsel has authority to settle a lawsuit worth 5% of the company's value? He seems to have actual belief, and if this is reasonable, then Spirit is bound by the Settlement.

(c) Estoppel: Under R3A §2.05, Spirit is estopped from denying it's bound by the Settlement, if:

- Carl suffered a detrimental change in position, which he didn't. If the Settlement doesn't bind Spirit, his claims are not waived and he can sue them;
- His belief that Lou was authorized was justifiably induced: which is possible (see 1b); and
- Spirit's culpability: no evidence of intentional cause of the belief. Perhaps Spirit has notice of Carl's belief or negligently caused it by allowing Carl to discuss settlement in their headquarters.

No detrimental change in position, so no liability based on estoppel.

2. Sale Suit:

(a) Duty: Defendants owe FD to Spirit as directors.

(b) SoR: Like the directors in *Morgan*, Pam and Pete aren't conflicted because the preferred shares are participating, so they share with common SHs in any increase in purchase price. Their personal interest, like the common SHs, is to get the highest price possible.[3] Enhanced Scrutiny applies under *Unocal* because the board is

[1] Some students wrongly applied the tort (rather than contract) framework, relying on R3A§7.04 and 7.08 instead of R3A§2.01 and 2.03, and analyzing Respondeat Superior and negligence. While they received some credit for correct actual and apparent authority analysis, they incurred a large penalty for applying an incorrect framework.

[2] Some students stated that "Lou is an officer, and therefore an agent". This is a wrong answer because it is not the legal test in R3A§1.01. To establish agency, you need to cite facts from the fact pattern that show that A acted on B's behalf and subject to B's control.

[3] Perhaps the most common mistake on the exam was arguing that Pam and Pete are self-dealing because they own the preferred SH and approve a deal in which preferred SHs get something and common SHs get nothing. However, for Pam and Pete to be conflicted you need to show they have a personal interest that conflicts with Spirit's interest. In this case (as in *Morgan v. Cash*) the shares are participating, so if Pam

deploying corporate power against SHs' right to vote against the deal, by having a termination fee if the deal is rejected, and it applies under *Revlon* because the board is embarking on a transaction that would result in CoC (sale to Cheapskate).

(c) Application – Legitimate purpose: No illegality in selling Spirit, and no corporate waste, since no better valuation came up in the search, so a reasonable person might believe that $20M is best price SHs can get.

(d) Application – Reasonable investigation: Carl concedes this.

(e) Application – Good faith: The board wasn't self-dealing (see 2b).

(f) Application – Reasonableness: The Sale Agreement isn't preclusive, because both SHs and the board have 60 days to reject the agreement.[4] A termination fee of <3% isn't coercive. The board searched for better offers twice pre-sale, and can also shop for 60 days post-sale, so not otherwise unreasonable. Carl's evidence of a higher valuation isn't relevant under Enhanced Scrutiny, which examines the reasonableness of the process, not the fairness of the outcome. Weak but possible argument that authorizing a conflicted person to negotiate the deal is unreasonable (Olivia has an incentive to sell Spirit to get the exit bonus and signing bonus, even if waiting for a better offer is preferable to SHs). Conclusion: probably no FD breach.

(g) The SH vote wasn't ratification, because all votes in favor came from the directors seeking ratification (so approver has CoI regarding the behavior that's approved).[5]

<u>3. Abetting Suit</u>:

Cheapskate may have abetted three possible FD breaches. For all three breaches, the element of damages proximately caused by the breach equals the fair value of Spirit's common shares (which is zero unless Spirit's value is >$30M). The other three elements are analyzed below for each potential FD breach.[6]

(a) Board breach: Spirit's board owes a FD to plaintiffs. It probably didn't breach FD (see 2a-f). Even if it did breach, Cheapskate didn't create or exploit a board conflict, so no knowing participation.
(b) Olivia breach (exit bonus): Olivia owes a FD to plaintiffs & Spirit because she's an agent, acting on Spirit's behalf as CEO and subject to the board's control. While her exit bonus was an authorized benefit, it caused Olivia's personal interest to desire a

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and Pete believed they could get a higher price for Spirit, now or in the future, the preferred SHs would share in this higher price, so their interests are aligned with those of the common SHs.

[4] Some students wrongly argued that the challenged action was preclusive because common SHs lacked the votes to block the sale. But the inability of common SHs to block the deal is a result of the number of shares outstanding and their voting rights, not of the challenged board decision. The board's actions didn't preclude common SHs' ability to block the deal; they simply didn't have that ability.

[5] DGCL §144 doesn't apply because this isn't ratification of self-dealing (which is what §144 covers). The correct rule to cite was the principle that an approver can't have a CoI regarding the approved behavior.

[6] To establish liability, all four elements of aiding & abetting must apply to the same defendant and the same (alleged) FD breach. Some students matched different elements to different acts (or even different defendants), such as assessing duty and breach by the board, but then assessing knowing participation in a FD breach by Olivia (the CEO).

sale within two years, even if SHs would benefit from selling later. So, in negotiating and recommending the sale she acted while conflicted, breaching FD. The board's appointment of Olivia to negotiate the deal while knowing about the exit bonus is an informed ratification, though (DGCL §144(a)(1)). Cheapskate knew of the conflict but also of the board's authorization/implied ratification. In any case, Cheapskate didn't create or exploit Olivia's conflict (except by threatening to walk, which is consistent with arm's length negotiating).

(c) Olivia breach (signing bonus): Olivia owes a FD to plaintiffs as an agent (see 3b). The signing bonus is a benefit. It may genuinely come from Olivia's skill (not from fiduciary position), or perhaps it comes from her position as Spirit's negotiator (a bribe to accept the offer). Even if it's not an unauthorized benefit from fiduciary position, the signing bonus makes Olivia want to negotiate with and recommend a sale to Cheapskate, even if it isn't the best option for the shareholders, therefore breaching FD through CoI. But the board knows about the Side Agreement and approves the Sale Agreement, which is likely an informed ratification under DGCL §144(a)(1) (though not if it's ambiguous – the board may like the Sale Agreement even if it doesn't approve of the Side Agreement). If board approval of the Sale Agreement isn't ratification, Cheapskate certainly knowingly participated by creating this conflict of interest – unlike *Morgan*, in which employment terms were identical to those the CEO already had, here Cheapskate adds a signing bonus; also unlike *Morgan*, here the CEO was involved in negotiating the deal.