

Student Number _____

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

Unincorporated Business Entities

Professor Amitai Aviram

Fall Semester 2005: Dec. 14, 2005

Number of Pages: 4 (including this page)

Time Allotted: 3 hours

Exam Instructions

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. **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.
4. **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.
5. **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. 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. Discuss the applicable rule and result for the various possible fact patterns.
6. **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.
7. **Choice:** The exam contains three questions. Answer any two of them. I will only grade the two questions you answered first.
8. **“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!

Essay Fact pattern (answer TWO of the three questions):

It was a cold winter night in Chicago and the streets were covered with snow and ice. As Don turned the corner of a street his car got stuck on a snow bank. His attempts to drive out of it were to no avail. He got out of the car and tried to push it off of the snow bank, again with no success.

Carol, a taxi cab driver working for Orange & Blue Taxi Company, LLC (“OBT”), drove by. Seeing Don in distress, Carol stopped to help. She helped Don push the car, but even their combined forces were not enough to get the car un-stuck.

Don offered Carol \$100 if she would use the cab to tow his car out of the snow bank. Carol did not have the equipment to tow the car, but was willing to use the cab to push Don’s car out of the snow bank. Don paid her \$100.

Carol moved the cab behind Don’s car and drove slowly forward. For a few seconds, the car wouldn’t budge. Then it pushed out of the snow bank, skidded sideways on the smooth ice that covered the road, and crashed into Paul’s luxury car, which was legally parked on the side of the street. Paul’s car, worth \$150,000, was totaled. Assume that, given the icy conditions, a person using a car to push another car without taking additional precautions would be liable for negligence.

When Paul discovered his wrecked car (with a post it note providing Don’s contact information), he hired Lisa, a partner at the law firm of Swindle & Crooke, LLP (“S&C”). Lisa discovered that Don has no more than \$20,000 in assets. She interviewed Don, who told her how the accident occurred. Lisa found that Carol has only about \$30,000 in assets. OBT, however, is a very prosperous company.

Lisa’s investigations revealed that OBT owned the cab and had an insurance policy covering traffic accidents, but not accidents caused by using the cab to push other cars. Carol was a salaried employee of OBT – it paid Carol a fixed salary, and Carol remitted to OBT all of the revenue she received from passengers. The accident occurred just minutes after Carol dropped off a passenger, and was told by OBT’s dispatcher to pick up another passenger in 30 minutes. OBT imposes many rules on its taxi drivers, including rules regarding the use of the cab. One of these rules expressly prohibits drivers from using a cab to push or tow cars, requiring that a tow truck would be called instead. OBT never makes active investigations, however, to detect whether taxi drivers violate that rule.

Lisa invited Carol to discuss the accident. Lisa explained that according to the evidence she has gathered, Don, Carol and OBT are all liable to Paul for the damage to his car. She and Carol agreed to settle the suit. Lisa and Carol signed a document stating that OBT is accepting responsibility and will pay Paul \$120,000, in settlement of all claims Paul has against OBT, Carol and Don regarding the damage to his car.

Lisa then sent a copy of the document to OBT, and requested payment of \$120,000. Mandy, OBT's General Manager, rejected the claim, stating that OBT is not liable for the accident, and is not bound by the document signed by Carol.

I. Analyze both of OBT's claims: (1) Whether OBT is liable to Paul for the damage to his car (not taking into account Carol's consent to the settlement document); (2) Whether OBT is bound by the settlement document signed by Carol.

Lisa received a letter from Mandy rejecting OBT's responsibility. She informed Paul, and they agreed to sue OBT, claiming both that OBT is liable for the damage to Paul's car and that OBT agreed to settle the lawsuit. Lisa began preparing the lawsuit, but when it was ready Paul asked to wait so that he could amicably negotiate a settlement with Mandy. Mandy negotiated with Paul, but they did not reach a compromise.

Three days before the statute of limitations was to run on Paul's claim, Paul asked Lisa to sue OBT. S&C always outsources less profitable aspects of litigation such as serving process. Therefore, Lisa picked Speedy Service, LLC ("SSL"), a company that specializes in serving process, and hired it to serve process on OBT (which would toll the statute of limitations). SSL is an Indiana-based company, and it regularly trains and instructs its employees according to developments in Indiana civil procedure.

S&C had never used SSL before. However, since SSL specialized in service of process, S&C trusted that they knew their job, and did not issue and instructions or requests other than providing OBT's address and explaining the urgency of serving process that day.

Elmer, SSL's employee, went to OBT's office and served the process on the receptionist. This would have sufficed to serve OBT under Indiana laws, with which Elmer was familiar. However, the suit was brought in Illinois and under Illinois laws process had to be served on OBT's General Manager in order to be considered served on OBT. Thus, process was not considered served on OBT. The next day, Lisa learned of Elmer's mistake, but the statute of limitations had already run.

When Paul learned of this, he sued S&C and Lisa.

II. Analyze both Paul's suit against S&C and his suit against Lisa.

OBT, meanwhile, has prospered, expanding its taxi business and also renting its excess cabs to interested parties. OBT registered as a member-managed LLC. Upon its formation, OBT issued three shares – one each to Oliver, Beth and Mandy. They all agreed to appoint Mandy as OBT's General Manager.

According to OBT's operating agreement, any person holding shares issued by OBT is a member of OBT, and has a number of votes in member meetings equal to the number of shares he or she owns. The shares can be transferred to another person only if all other

OBT shareholders consent. A share can be unilaterally redeemed by OBT for \$10,000, by a written proclamation of the General Manager, if the General Manager believes that the member has willfully breached the operating agreement. The General Manager's discretion is deemed to be final and members may not appeal the decision in any court or arbitration forum.

The operating agreement also states that distributions made by OBT to its members will be divided in proportion to the number of shares each member owns, and that upon dissolution, each member is entitled to a portion of OBT's assets proportional to the number of shares owned.

Further, OBT's operating agreement states that the members have no authority to bind the LLC to third parties; that the sole authority to bind the LLC lies in the hands of the General Manager and that OBT will not be liable to third parties for obligations not made or approved by the General Manager.

One day Oliver met Wayne, a professional race car driver. Oliver thought that associating OBT's taxi business with a famous driver like Wayne would help OBT's business. He therefore offered Wayne that OBT would lease a cab to him for one year in return for a nominal amount of \$1 and Wayne's promise to conspicuously drive the cab (which has OBT's logo on it). Wayne agreed.

Mandy did not believe that OBT can benefit from having celebrities drive its cabs, and when she heard of the deal, she was very upset. She refused to rent Wayne a cab. She also deemed Oliver's behavior a violation of the operating agreement (which states that only she can bind OBT), and told Oliver that she will redeem his share. Oliver raised some technical objection to her ability to redeem his share. Mandy disagreed, but told him that she would check this issue with OBT's lawyer, and will return with an answer tomorrow as to whether his share can be redeemed.

Oliver quickly drove to Beth's house and persuaded her to replace Mandy with him (Oliver). Oliver and Beth signed a letter specifying that they are removing Beth from her position as General Manager and appointing Oliver in that position. No formal meeting of members was called for.

The next day, Mandy met with Oliver and told him that the lawyer confirmed her position, that she can redeem Oliver's share. Oliver informed her that she is no longer the General Manager, and that he, as the new General Manager, views her threat to redeem Oliver's share as a breach of Mandy's fiduciary duties and of the organizational agreement, and therefore he is redeeming her share. Oliver signed a written proclamation to that effect.

III. Wayne sued OBT to enforce the cab rental agreement. Mandy sued OBT to enjoin her removal from the position of General Manager, and enjoin the redemption of her share in OBT. **Analyze Wayne's suit and Mandy's suit.** Assume that the relevant jurisdiction follows the ULLCA.

Unincorporated Business Entities – Fall 2005
Memo on the Final Exam

Grades:

Raw scores were calculated out of a total of 100 points: A 40 point maximum for participation, and 30 points for each of the two essays selected on the exam. Below are the average, median, lowest and highest grades for the exam and for each essay separately:

	Average	Median	Lowest	Highest
Essay 1	20.69	21	8	29
Essay 2	16.14	15	7	25
Essay 3	16.44	16	11	21
Participation	30.13	29	22	40
Total (including participation)	67.31	65	47	90

Grades were given based on the percentile ranking of the exam's total raw score. 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. Students may receive credit for very different, but correct and well-explained responses.

Question I (OBT's Claims)

1. Is OBT liable to Paul for the damage to his car?

(a) We are to assume that Carol is liable to Paul in torts for her negligence in pushing Don's car. Carol is clearly OBT's agent: she drives a cab for OBT, she is subject to OBT's control (rules imposed by OBT), and consented to this (Restatement §1).

(b) OBT's liability for Carol's actions depends first on whether Carol is an employee or an independent contractor. Restatement §2(2) and 220(1) define an employee as an agent whose physical conduct is controlled by the principal. Restatement §220(2) offers ten factors in the determination. In this case, it seems that Carol is an employee (servant, in the Restatement (Second) terminology). As in the *Parker* case, OBT has detailed rules as to her conduct, amounting to control of her physical conduct. She is paid by the hour and does not receive the revenue from her work; OBT supplies her with the instrumentalities of her work (the cab). OBT may not enforce the rules with which it controls its agent's physical conduct, but it has the legal right to enforce them, and therefore is deemed to have control over the agents' physical conduct.

(c) Was the tort committed within the scope of Carol's employment? Restatement §230 clarifies that an act may be within the scope of an agents employment even if it was

forbidden by the principal, as pushing a car with the cab was in this case. Restatement §228(1) sets the rule for identifying the scope of employment. The conduct that created the tort must be:

- (i) Of the kind Carol is employed to perform – this does not exist here. Carol’s assistance to Don is of a purely personal nature, as in *Bolwin*. At most, her job created the opportunity for her to commit the tort, by having her drive by Don’s car. This does not suffice to place the liability on the employer (*Haddon*);
- (ii) The tort occurred substantially within the authorized time and space limit – In this case, this element is satisfied – there was no “frolic or detour”;
- (iii) It is actuated, at least in part, for the purpose of serving OBT – In this case, there does not seem to be any purpose of serving OBT. This element was replaced in some jurisdictions by *Bushey*’s foreseeability element. The existence of a rule prohibiting the use of a cab to push (rather than tow) another car suggests some foreseeability. However, this case fits the two qualifications in *Bushey*: the risk of a Carol using her cab to push Don is no greater than the risk that this will be done by any other car owner, and Carol’s motivation was unrelated to her employment. Thus, this element is not satisfied under both the purpose and the foreseeability tests.
- (iv) If force is intentionally used by the agent against another, the use of force must not be unexpected – here, force was not intentionally used against another.

Conclusion: The tort was outside of Carol’s scope of employment.

(d) Is OBT liable to Carol despite the tort being outside of the scope of employment? Restatement §219(2) specifies the exceptions, and none apply here: OBT did not intend the consequences, nor was it negligent or reckless; the tort did not involve a non-delegable duty assigned to the agent; and Carol did not purport to act on behalf of OBT in a manner that would create apparent authority.

Conclusion: OBT is not liable to Paul for Carol’s tort.

2. Is OBT bound by the settlement document signed by Carol?

(a) Since OBT did not ratify the settlement nor are there grounds for estoppel against it, OBT would be bound by Carol’s signature of the settlement document only if Carol was its agent and had authority to bind OBT on this matter.

(b) Carol is OBT’s agent (see I.1.a).

(c) Carol did not have actual authority, since OBT specifically forbade her to use the cab to push other cars.

(d) Carol would have apparent authority if:

- (i) OBT made manifestations to Lisa that are the source of-

(ii) Lisa's actual belief that Carol had authority to sign a settlement that would be binding on OBT; and

(iii) Lisa's reasonable belief that Carol had authority to sign a settlement that would be binding on OBT.

OBT's sole manifestation to Lisa was that Carol was its cab driver. Whether or not this was sufficient to cause Lisa to actually believe that Carol had authority, it is clear that no reasonable lawyer would believe that a cab driver with no legal experience is authorized to settle lawsuits for the company and obligate the company to pay \$120,000. Therefore, there is no apparent authority.

(e) Does Carol have inherent authority? Lisa knows that OBT is Carol's principal, so this would be a disclosed principal situation, covered by Restatement §161. Carol would have inherent authority if Lisa's actual and reasonable belief of Carol's authority can be based on Carol's acts that "usually accompany or are incidental to transactions which [Carol] is authorized to conduct." As a cab driver, Carol is authorized to transport passengers and accept money from them for the transportation. Towing cars is neither incidental nor usually accompanies these. Therefore, Carol has no inherent authority to settle suits for OBT.

Conclusion: For lack of authority, OBT is not bound by Carol's consent to the settlement.

Question II (Paul's Suits)

1. Paul's suit against S&C

[In this answer below, discussion of issues similar to the ones that arose in question 1 will be brief. On the exam, if a student did not answer question 1 or did not refer in question 2 to relevant portions of his or her answer in question 1, a more complete discussion, similar to that in question 1, was expected.]

(a) Elmer was negligent. Since S&C hired SSL and not him specifically, we must first check if SSL is liable for Elmer's negligence. Elmer is an employee of SSL (for the test see I.1.a (Elmer is an agent) and I.1.b (Elmer is a servant). Was his behavior within the scope of his employment? Clearly yes, according to both Restatement §228(1) and *Bushey*: It is of the kind he is employed to perform, it occurred within the authorized time and space of his employment; it was actuated with the purpose of serving the employer (Restatement version of element 3), and it was foreseeable by the employer that Elmer would use the Indiana laws which he was trained to use (*Bushey* version of element 3). Thus, SSL is liable for Elmer's negligence.

(b) Is S&C liable for SSL's negligence? SSL was S&C's agent: it served process on behalf of S&C, was controlled by S&C (which specified who to serve the process to), and SSL consented to this relationship (Restatement §1).

(c) Was SSL a servant of S&C? Probably not. Restatement §2(2) and 220(1) define an employee as an agent whose physical conduct is controlled by the principal. Restatement §220(2) offers ten factors in the determination. Unlike the *Parker* case, S&C imposed very little control over SSL – it did not direct it in any way except for expressing urgency, and S&C is in a different business than SSL – one specializes in serving process and the other never serves process. Thus, SSL is not a servant of S&C, but an independent contractor (of the agent type).

(d) Is S&C liable for its independent contractor's tort? This would happen if: (i) S&C retained control of the area of activity in which the tort occurred – this did not occur in our case; (ii) The contractor's task is inherently dangerous – again, not relevant to this case; (iii) The duty to serve process is non-delegable – one court (*Kleeman v. Rheingold* – not in the course material) determined that the duty to serve process is indeed non-delegable and therefore a law firm is always liable for torts of the independent contractor regarding that duty (this decision has been criticized as wrong). However, there is no indication in the fact pattern that the duty is non-delegable, so students would be right in assuming it is not; (iv) According to Restatement §213 and 219(2)(b), S&C would be liable if it was negligent in picking an incompetent independent contractor. This seems to impose liability on S&C in this case. Knowing that Illinois law would apply and that SSL is an Indiana company, S&C should have either picked an Illinois firm or ensured that SSL is familiar with Illinois law regarding service of process.

Conclusion: Because S&C was negligent in picking SSL to serve process, it will likely be liable despite SSL being an independent contractor rather than an employee.

2. Paul's suit against Lisa

(a) S&C is an LLP. Under RUPA, partners in an LLP are not personally liable for the obligations of the partnership (*Dow, Megadyne*). Therefore, Lisa would not be liable for S&C's liability to Paul solely as a partner in S&C.

(b) However, Lisa negligently picked SSL to serve process in Illinois. It is her negligence that caused S&C to be liable, and she is personally liable to Paul for this negligence (S&C's liability is derivative from her liability, not the other way around). Therefore, as the court in *Megadyne* suggested possible, Lisa is directly liable to Paul for negligence.

Question III (Wayne's Suit and Mandy's Suit)

1. Wayne's suit

(a) Despite the extensive powers that it gives to its General Manager, OBT is a member-managed LLC. According to ULLCA §301(a), each member of a member-managed LLC is an agent of the LLC for the purpose of its business, and an act of a member for apparently carrying on in an ordinary course the company's business binds

the company (unless the partner had no authority to act and the third party had notice of the lack of authority).

In this case, OBT is in the business of leasing cabs, so leasing a cab to Wayne is apparently in the ordinary course of its business. Does the exception apply?

(b) The operating agreement attempts to opt-out of the default rule (in ULLCA §§301 and 404) that members manage the member-managed LLC. This opt-out is not prohibited under ULLCA §103(b), except to the extent that it attempts to void third parties' rights ("OBT will not be liable to third parties for obligations not made or approved by the General Manager"). This would violate ULLCA §103(b)(7). However, as far as the relationship between the members is concerned, Oliver lacks authority to bind OBT.

(c) We have no evidence that Wayne had knowledge of Oliver's lack of authority (or, in general, of OBT's operating agreement, which is not a public document). Because Wayne had no knowledge that Oliver lacked authority, and since renting cars was in OBT's apparent ordinary course of business, Oliver bound OBT to the agreement he reached with Wayne. Wayne is entitled to rent a cab from OBT for \$1.

2. Mandy's suit – Removal as General Manager

(a) Who has the power to remove the General Manager? According to ULLCA §404(a)(2), any matter relating to the business of a member-managed LLC may be decided by a majority of members, unless it is excluded in ULLCA §404(c). OBT did not opt out of this arrangement – it only addressed the authority to bind OBT to third parties. ULLCA §404(c) does not address decisions to appoint the LLC's officers. Therefore, a majority of members may remove the General Manager and appoint another.

(b) The decision to remove Mandy from office was not made in an official member meeting. However, this is permitted by ULLCA §404(d).

(c) The decision to remove Mandy was opportunistic. Oliver knew that Mandy would object to it so he did not call for a member meeting but met separately with Beth, during a time that he knew Mandy would be away to clarify the technical issue that Oliver raised to postpone the redemption of his share. This may seem to invoke *Castiel*, in which this breach was seen to invalidate an otherwise valid decision (there – to merge the LLC so as to shift control of the LLC to another member). However, this case can be distinguished from *Castiel*. First, the secrecy did not harm Mandy, since she could not have prevented her removal even if a meeting was called and she was present and objected – since unanimity is not required (see III.2.a) the decision would still have passed by a vote of 2-1. Second, this action seems to affect Mandy in her role as OBT's General Manager, not in the role of a member of OBT. Members of member-managed LLCs have fiduciary duties to other members and to the LLC (ULLCA §409), but not to officers of the LLC.

Conclusion: The court would likely not enjoin Mandy's removal from the office of General Manager.

3. Mandy's suit – Redemption of Her OBT Share

(a) Is the redemption clause in the operating agreement valid? The redemption clause purports to allow the General Manager to redeem a member's shares based on a subjective judgment of the member's actions, and prevents courts from second-guessing this judgment. Since membership is defined by the ownership of shares, the redemption clause is an expulsion clause. ULLCA §103(b)(5) prohibits clauses that vary the right to expel a member in an event specified in Section 601(6). Section 601(6) allows the expulsion of a member by judicial determination that the member acted in certain ways, including the manner specified in OBT's redemption clause ("the member has willfully breached the operating agreement").

The operating agreement does not prevent a court from expelling a member for breaching the operating agreement, but allows the General Manager to expel a member for the same reason. Does this "vary the right to expel a member in an event specified in Section 601(6)"? The interpretation of ULLCA §103(b)(5) is ambiguous. If "varying the right" includes allowing someone other than a court to expel a member for the same (subjective) causes, then the redemption clause is invalid. If "varying the right" only regards protecting members from a court's power to expel members, then the clause may fill content into ULLCA §103(b)(2) (which allows expulsion upon an event specified in the operating agreement), and would be valid. The former interpretation protects minority LLC members; the latter protects the freedom of contract in forming the LLC.

(b) If the redemption clause is held valid then Oliver can expel Mandy, unless the expulsion would violate his fiduciary duty to Mandy. Under *Castiel*, an otherwise valid action can be enjoined if it results in a breach of fiduciary duty. Oliver owes Mandy, as a fellow member, a duty of good faith and fair dealing (ULLCA §409(d)). Redeeming Mandy's share to punish her for attempting to redeem his share seems to violate this duty. Therefore, a court may enjoin the redemption even if it holds the redemption clause valid.

(c) If the redemption clause is held invalid, who has the power to redeem shares? According to ULLCA §404(a)(2), any matter relating to the business of a member-managed LLC may be decided by a majority of members, unless it is excluded in ULLCA §404(c). ULLCA §404(c) requires unanimity for the admission of new members, but not for expelling members. However, ULLCA §601(5) allows the expulsion of a member by unanimous vote under certain circumstances (e.g., it is unlawful to carry on the LLC's business with that member). This section would be superfluous if the default rule was that members can be expelled by a majority vote. Therefore, it seems that at least by default expulsion requires a unanimous vote.

Even if a majority vote sufficed, there was not a majority to expel Mandy. Beth voted to remove Mandy from the office of General Manager, not to expel her from the LLC. Even if Beth had voted with Oliver to expel Mandy, and even if a majority vote sufficed, a court might enjoin the expulsion because it was done in violation of the duty of good faith (see III.3.b).

Conclusion: Whether the redemption clause is held valid or invalid, the court will likely enjoin the redemption of Mandy's share.