

Spring '04
15.617
THE LAW OF CORPORATE FINANCE AND FINANCIAL MARKETS

FIRST TAKEHOME EXERCISE
John Akula

Period During Which Exercise is Available:

Available beginning Thursday, April 1 at noon;
To be completed (within 3 hours of receipt) by Saturday, April 3 at 5 pm

Material Covered:

From Class 1 on 2/4 (Akula – Introduction)
Through Class 11 on 3/29 (Cable/Matarese's second class on Public Company M&A)
BUT from Class 6 only the materials on contracts and not the materials on business disputes

INSTRUCTIONS AND ADVICE

1. Schedule and timing. Make arrangements with the TA to have the exam e-mailed to you at a mutually convenient time, and then within **three hours** e-mail back to the TA the completed exam. Keep a hard and computer-readable copy of your exam.

2. Sources and communication among students: During the period the exercise is available, students may not consult with each other about the course. For the exercise, you may consult the text, the readings, and any notes prepared by you, but no other sources. (Since your answers will be evaluated in terms of the course readings and the lectures, especially the readings, consulting other sources would not likely do much good.)

3. Weighting and strategy: There are two questions. Answer both. They will be weighted equally. Each particular point you should address appears in a sentence ending with a “?” Don’t neglect to respond to each “?”

4. Format and submission of answers: Your answer should have a cover sheet which includes your name, “ESL” if English is your second language, and the exact word count for the entire document. Start the answer to each question on a fresh sheet. **Your entire submission should not exceed 1,000 words.**

5. Some general advice (READ THIS CAREFULLY): You are not supposed to be a lawyer, and I don’t expect you to have definite answers to legal questions. You are supposed to be a manager with the ability to make a **preliminary** assessment of legal problems. Each question will ask you to address legal issues in a business context from the point of view of a manager. It doesn’t matter much if I don’t agree with your judgment as to how serious a risk or problem is, so long as you spot it and understand the legal and managerial implications of it. Your answers should demonstrate your understanding of and ability to express broad legal concepts, and your ability to spot where and how the law will have an impact on a business problem and the individuals involved. It will not be necessary to cite specific cases or statutes. **Make sure that your answer focuses on how general legal principles apply to the facts you have been given.** To the extent that the facts are not as specific as you would like them to be for your assessment, point that out. You shouldn’t concern yourself with implausible possibilities. I don’t try to “trick” people in these exams. Look for the main issues suggested by the facts, and get right to them. **Be responsive in your answer; that is, answer the specific questions that have been asked from the perspective you have been asked to assume.** (For example, if you are asked to provide some alternative courses of action, do so. If you are asked to assess risk from the perspective of a particular party, do that.) Your answers should be well-organized and clearly written. The length limit is tight, so you will probably have to edit your answers carefully to cover the necessary points in the limited space allowed.

6. Grading: If your exam is over the length limit, or submitted late, there will be a downward adjustment to your grade.

7. Originality: Your answer must be in your own words, unless you use quotations and give a source. Do not copy (or copy with only a change in a word or two) material from the readings into your answer.

NOTE TO ESL STUDENTS: If English is your second language, and you are having trouble understanding the wording of a question, you can try to call me or the TA for help.

Question #1.

You are Smarty Aleck, and you graduated from Sloan 12 years ago. You are now a senior manager at BigCo, a publicly-traded corporation that manufactures medical devices, and that has expanded its business lines significantly in recent years but has never acquired another company. The CEO at BigCo is Ms. Top Dog, an engineer by training and very strong on the product design side of the business but weaker on finance. One of the reasons Top hired you is your expertise in acquisitions.

Top is thinking seriously about acquiring LittleCo, a privately held medical devices firm. She is somewhat unsure that she fully understands how the deal might be structured, and she wishes to begin clarifying her thinking on this issue without spreading word internally at this time. She therefore has called a meeting with you to discuss the matter in confidence before deciding to engage other parties.

Top believes that approximately two-thirds of LittleCo's product line presents "numerous synergies", yet she is open to buying the entire business. Since BigCo very recently spent a significant amount of cash on a major expansion, Top would prefer to purchase LittleCo solely for stock. In considering this potential acquisition, however, Top has become concerned that BigCo remain as insulated as possible from liabilities arising from LittleCo's existing medical device products. She also wants LittleCo's rights under its existing contracts to carry over to BigCo. Finally, Top desires that any proposed acquisition of LittleCo close quickly with as little back-and-forth over the purchase price as possible.

Given Top's above objectives, what are the non-tax tradeoffs that you would advise her to consider when deciding between an asset purchase, a stock purchase, and a merger transaction?

Question #2.

You are still Smarty Aleck, working for BigCo. It is one month since BigCo acquired LittleCo. After the acquisition, a decision was made to completely integrate the production facilities and personnel acquired from LittleCo into BigCo, and you are in charge of that process.

Yesterday Ned Nervous, who is in charge of quality control systems for BigCo and is assisting in the integration, came into your office. Ned said he had some bad news. Last week, Ned was reviewing some of LittleCo's internal quality control reports from the few months prior to the acquisition, and discovered a troubling pattern. The FDA requires that quality control problems be reported to the FDA. Failure to make a required report is always treated as a serious matter and sometimes as a criminal matter if the lapse is significant enough. However, the regulations are not clear on how significant a problem must be to trigger the requirement of a report.

Ned believes that LittleCo., on at least three occasions during the few months prior to the acquisition, did not report certain quality control problems to the FDA of a kind which it had been reporting earlier and which BigCo would report. However, Ned is not sure that this was a violation of FDA standards, since the standards are not clear. Ned also does not know if the unreported quality control problems had any impact on the quality of LittleCo's products. He says he thinks such an impact would be unlikely because there was probably no impact at all on production and, in any event, other quality screens would probably have pulled out any defective items, but he can't be sure. Although you generally have confidence in Ned, you are worried that since he was heavily involved in the evaluation of LittleCo's quality controls during the due diligence process, he may be inclined to minimize this latest problem.

If there were any defects in the products produced by LittleCo, the products liability exposure to BigCo would be substantial. Moreover, the question of whether a defect exists and how it originated is not always clear in the kind of litigation which LittleCo's products have generated in the past, so even a showing of a lapse in quality controls without any clear evidence of a causal link to a clearly defective product could hurt BigCo in litigation. Any quality control-related reports to the FDA become a matter of public record and will give the lawyers for any plaintiffs a road-map to the problem Ned has uncovered.

Right after speaking with Ned, you called Top on the phone and will be meeting with her later today. Top made clear that the integration of the LittleCo assets into BigCo is too far along to reverse, so that process will continue to go forward, and she is prepared to assume for the moment that BigCo cannot insulate itself from any products liability that may arise. She also made clear that she is putting you in charge of coming up with a plan to deal with the problem which Ned uncovered. Given her initial comments, you know you are going to have to address three points at the meeting, and you are preparing your thoughts:

What should BigCo do to manage and minimize the risk of liability to consumers who might allege that they were harmed by any lapses in quality control?

What should BigCo do with respect to the potential concerns of the FDA about possible lapses in reporting?

What other steps should BigCo take to manage this problem?