

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

SECOND TAKEHOME EXERCISE
John Akula

Period During Which Exercise is Available:

Available beginning Tuesday, May 4 at noon;
To be completed (within 3 hours of receipt) by Thursday, May 6 at 9 pm.

Material Covered:

From Class 12 on Monday 3/29 (Walek – International M&A and Joint Ventures)
Through Class 21 on Monday 5/3 (Akula – Antitrust)
BUT from Class 13 just the Bagley readings, and not the employment materials discussed in
class.

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 have two friends, Dick and Jane. Dick is a computer scientist. Jane is a radiologist (a physician who reads X-rays and other diagnostic scans). A few years ago, Dick and Jane (“D&J”) formed a corporation called ScanTech, and since then have been working on the problem of developing a computer-driven system for comparing diagnostic scans. Such a system would be an important advance, but the development presents many problems.

D&J have solved some key development problems, but other problems remain. Solving the remaining problems will be expensive. Having invested all of their personal savings into ScanTech, D&J are seeking to raise working capital from investors. In exchange for your frequent business advisory services, D&J have provided you with a 10% stake in ScanTech and now wish to receive your advice on the following three concerns.

A. D&J are considering venture capital financing. However, they are not willing to commit to a timetable for the completion of product development. (D&J believe they probably will complete the project within 5 years, but they wish to take even 15 years if necessary.) D&J have heard that a venture capitalist (VC) usually pushes a portfolio company for significant financial returns over a short time period. They have asked you what general legal provisions a VC would typically use to establish a time period for return on investment, and how effective these provisions are likely to be. **What would be your response? Given D&J’s approach to timing, do you believe they are likely to find a VC investor, and why or why not?**

B. D&J are also considering contracting with a “strategic investor”. They have had some preliminary conversations with Blondie, a large Swedish corporation that manufactures medical devices for sale throughout Europe. Blondie may be willing to invest substantial funds in a joint research and development effort, so long as Blondie is granted full intellectual property rights in Europe for the work which D&J have already done and for any further advances that grow out of the joint venture. D&J are willing to permit this, but they want assurances that Blondie will not be able to take over the U.S. market. **What is your assessment of the risks under the U.S. antitrust laws of attempting to protect ScanTech from penetration of the U.S. market by Blondie, and why?**

C. If they proceed with a joint venture with Blondie, D&J want the main activities to take place in the U.S. Blondie will accept this if the joint venture is established as a separate entity. The parties have begun referring to this proposed separate entity as “JVE” (joint venture entity). D&J have expressed three concerns about the structure of JVE. First, they are worried that the collaboration might fail or that Blondie may figure out a way to stop funding, in either case leaving JVE with substantial liabilities. D&J want to protect ScanTech as much as possible from liabilities that might attach to JVE. Second, if JVE is doing well, D&J think it is likely that JVE will take on an increasingly broad operational role and might eventually in effect “take over” most of what ScanTech does as the primary base for all U.S. activities. Third, everyone anticipates that JVE will suffer substantial losses throughout its early years, and D&J would like to have the immediate tax benefits of those losses. **In light of these concerns, what form of legal entity would you suggest for JVE? If all of these concerns cannot be realized by a single kind of entity, what are the main tradeoffs among the possible alternatives?**

Question 2

You are the CEO of HotCo, a privately-held company. HotCo was organized five years ago to commercialize a new approach to manufacturing the WhatIsIt, a component in electronic devices. It is now clear that, using HotCo's technology, the WhatIsIt can be produced for \$5. HotCo's most efficient competitor can only make a WhatIsIt for \$6.

Investor interest is high because of this price advantage, and HotCo is planning its initial public offering. The effective date of the public offering is three weeks away, and right now you are on the "road show" with the underwriters.

However, you just received a phone call from Back Slapper, your Vice President for Human Resources, with some troubling news about Whiz Kid, HotCo's head of research. Whiz's secretary is Tess Truthful. Back Slapper has just told you that earlier today Tess came into his office and told Back Slapper the following story.

According to Tess, ten days ago Whiz drafted a progress report on his research. He writes such reports from time to time, whenever he thinks it is appropriate. Tess typed and edited Whiz's draft. The report stated that the research team is now almost certain that, with some small changes in the manufacturing approach, HotCo could produce the WhatIsIt for only \$3. However, right after Tess finished typing the report, Whiz called her into his office. He first confirmed that Tess had not discussed the report with anyone else. Then he asked for "all copies." He told Tess to delete the report from her computer hard drive, and "forget everything about that report." A few days later, Tess told Whiz that she felt uncomfortable, because she didn't like to lie to co-workers and she would probably be getting questions about when the next progress report would be coming out. Whiz told her that if she was smart, she would "do what I am going to do and my brothers are going to do" and buy up as much stock in HotCo as soon as she could right after the public offering, because a few weeks later HotCo's stock would "really shoot up." Tess left the meeting even more uncomfortable, and a few days later came to talk to Back Slapper.

You are about to call Lucy Lawyer, the partner at HotCo's outside law firm to whom you turn when you think you may have a serious problem.

What do you think Lucy is going to advise you to do in connection with the insider trading laws, and why?

What do you think Lucy is going to advise you to do in connection with the public offering process, and why?