

**15.649 - THE LAW OF MERGERS AND ACQUISITIONS**

**FIRST TAKEHOME EXERCISE**

**Period During Which Exercise is Available:**

Duration: 3 Days

**Material Covered:**

All material from Class 1 (Mahoney) through Class 5 (Rodriques)

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## 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 **90 minutes** 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.) You will want to have available to you a complete set of the required readings, including any sample documents.

**3. Scope of answer:** 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. **Your entire submission should not exceed 500 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. The exam 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.

**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. If you cannot reach either of us, you may ask any fellow student who is not enrolled in this class for help understanding the wording of a question.

You are Smarty Aleck (Sloan MBA '89), the President and COO of Flow Inc. Flow is a leader in the manufacture of small valves used as a component in hospital equipment for dispensing blood to patients during surgery. Flow's main customer is BigCo, the leading manufacturer of blood dispensing equipment. Both are based in Massachusetts.

Flow was founded by you and two other people: Dick (an engineer and the CEO), and Jane (a physician). The three of you run the company and own about half the stock. You have the strongest background in general management, so on business matters Dick and Jane look to you. The three of you sit on the board, along with directors appointed by the two venture capital firms that have invested in Flow. The venture capitalists own the rest of the stock, except for some small interests that have been given to a few key employees. Flow is a C corporation for US tax purposes, and all of Flow's business is in the US.

Flow has been growing steadily for the past several years, and business looks good. However, for a variety of reasons, all five major shareholders want to cash out soon. An IPO is not a practical option given market conditions. Fortunately, about six weeks ago BigCo expressed an interest in buying Flow. For reasons that are not entirely clear, BigCo wants to keep this deal simple and conclude it soon, and so discussions have moved forward quickly. There has been informal agreement on several key points. Payment would be in cash, since BigCo is closely held and none of Flow's shareholders are interested in BigCo shares. BigCo is willing to buy stock, and all Flow's shareholders are willing to sell. There was early discussion about an asset sale, but BigCo has agreed to a stock sale for two reasons. First, the eight key employees in Flow (including you, Dick and Jane) have signed non-competition agreements, and the lawyers have said those agreements would survive in the case of a stock acquisition. Those agreements are important to BigCo, and it is not clear how easy it would be to negotiate a new set. Second, third-party consents would be needed for the sale of some key assets but would not be needed for a stock deal, and although consents could probably be obtained it would take time. The parties have been talking about a \$50 million sale price. There has been no formal due diligence yet, but BigCo is confident that it understands Flow's business. There would be formal due diligence before a sale is consummated. The deal would sign and close on the same date. BigCo has not yet drafted a purchase agreement – BigCo has said it would contain “the usual stuff.”

However, in the past few days there has been an interesting development. Flow has always looked for other uses of its technology, and has a “new products” division that is to some extent operationally separate from the main production effort. So far, the new products have not amounted to much -- the valves for blood dispensing equipment account for 97% of sales. However, Flow has for several years been exploring the possibility of selling a different version of its valve for use in kidney dialysis equipment, which is potentially a much larger market. In fact, it has for the last three years manufactured such a valve and sold a small quantity to a major dialysis equipment manufacturer, Kidneys Inc. The Flow valve is a component in one innovative model of a Kidneys dialysis machine which has been in limited clinical use for about a year.

Dick is the main contact with Kidneys. He came back yesterday from a meeting with some top Kidneys executives and said “I've got good news and bad news.” The good news is that Kidneys has decided that the Flow valve, with modifications, could probably be an improvement on the valve they now use in most of their machines, and they want to talk with Flow about a long-term business relationship which would involve substantial sales. The bad news is that Kidneys may be facing a products liability lawsuit relating to the dialysis machine which contains the Flow valve. It appears now that the suit will not involve great exposure to

Kidneys, and that in any event there appears to be no direct relationship to the Flow valve. However, as a component manufacturer Flow will probably be brought in as a defendant even though it is unlikely that Flow will have to pay any damages.

After the meeting with Kidneys, you Dick and Jane met quickly and Dick raised the question of whether the deal with BigCo should be restructured as an asset sale, turning over to BigCo the production of the valve used in BigCo's machines, but allowing Flow to keep the new products effort and continue working on a valve for Kidneys. In some ways, this makes good sense. BigCo is a very focused company. It is unlikely BigCo would want to take advantage of this new opportunity or that BigCo would be comfortable striking a deal with Kidneys.

Dick then had a quick conversation with Flow's lawyer, Cool Smoothie. He and Cool talked about the fact that there would be some complicated intellectual property issues in dividing up Flow, but Cool said "I think those could be worked out." Dick also asked Cool if the potential lawsuit against Flow could be kept completely separate from the assets to be sold to BigCo. Cool said "Probably not – you are going to have to tell BigCo about the lawsuit."

Dick wants to meet later today with you and Jane, before he has another meeting with Cool. Dick knows that you understand M&A in a way that he and Jane do not, and he wants you to explain to him and to Jane some of the issues that are going to need to be discussed in the next meeting with Cool. In particular, he has asked you to think about the following:

1. If BigCo buys assets rather than stock, what will that do to the tax impact and how will it probably affect the price?
2. BigCo is going to want some strong non-competition agreements from all key personnel who remain with Flow. Can these be drafted in such a way as to permit both parts of this plan to go forward – the sale to BigCo and the continued new product work for Flow?
3. If we decide to do an asset sale, what other major terms in the purchase agreement that we expect BigCo to draft are likely to be affected, and in what ways?
4. We are pretty sure we will have to tell BigCo the bad news about the lawsuit. But how do we figure out whether and when we tell them about the potential for the new product?

Please prepare an outline of how you are going to approach these points.