

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

**SECOND TAKEHOME EXERCISE**

**Period During Which Exercise is Available:**

Duration: 3 Days

**Material Covered:**

All material from Class 6 (LeClaire on LBOs)  
through Class 10 (Carpenter on Distressed Companies)

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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.

## PROBLEM

[**Note:** The four questions you should answer are numbered and in **BOLD.**]

You are Indie Pendent. Two years ago, you became an outside director of MediumCo.

MediumCo manufactures a medical device called the “Threader.” The Threader is used in surgery to stitch up tears and incisions in muscles by inserting a loop of thread-like plastic around the tear or incision, tightening the loop, and then fusing the ends of the loop together. This method leaves a tie (or “suture”) that heals better than traditional thread sutures, especially when used in joints, where traditional sutures, which are tied with a knot, tend to tear or displace during movement of the joint. MediumCo has sales of about \$10 million a year. MediumCo owns several patents relating to the core technology for the Threader.

Three years ago, MediumCo. went public and is now listed on Nasdaq. However, there has not been much trading in the stock.

The board has six members – three insiders and three outsiders. The insiders are the top executives – Snoopy (the CEO), Droopy and Sneazy. The other two outside directors are a physician and an engineer. You are the only outside director with broad business expertise. You chair the Audit Committee.

Although the Threader is an advance in suture technology, and the potential market is enormous, sales have been disappointing due to minor mechanical problems with the Threader.

MediumCo’s financial statements for last year were an even bigger disappointment than sales, mostly because of some major write-offs. For about five years the company has made a large investment in several research projects relating to enhancing the Threader, but those projects have not yet yielded any major breakthroughs, although some engineers working on the projects remain optimistic. The write-offs relate to two of the largest research projects, and also a large accounts receivable as to which there has been a dispute with the purchaser. Also, in a variety of small ways MediumCo was very conservative in its accounting last year, and gave in to almost every suggestion by the auditors for conservative treatment of different audit items. You noticed this at the time the audit was wrapping up, but each of the judgment calls seemed defensible, and conservative accounting is in fashion in the post-Enron world. It occurred to you that management might be trying to position the company for a good year this year.

The recent performance of MediumCo’s stock has been an even bigger disappointment than the financial statements. This has reflected pessimism by top management on two key issues (in addition to the research-related write-offs). One is a dispute with another company over the validity of one of MediumCo’s key patents. The other are some medical malpractice liability claims. Management has let it be known that although MediumCo has a strong case on both issues, the outcome is uncertain and the potential costs are substantial. These liabilities have been footnoted in the financials, not quantified, but, along with management’s assessment, have had a substantial depressing effect on the stock.

Beginning about 18 months ago, there have been board discussions about finding a buyer for the company, or a strategic partner, because the company does not have much cash. Recently, these discussions have become more serious. One possible candidate is VeryBigCo, the nation’s

largest manufacturer of surgical devices. VeryBigCo has several products that are used in suturing, but does not have a product that uses fused loops like the Threader. Last week, Snoopy had lunch with two top executives from VeryBigCo and had an informal, tentative conversation. VeryBigCo may be interested in two possibilities: (i) a purchase of MediumCo; or (ii) a substantial investment in MediumCo coupled with a substantial loan to MediumCo. Snoopy has asked you to come to the next meeting with the VeryBigCo executives. These discussions will still be informal, and counsel will not be involved.

As you think about participating in these discussions, one concern you have is antitrust exposure. You are not worried about the antitrust implications of any deal that might eventually be considered, because the lawyers will have a chance to look that over. What you are concerned about are antitrust problems that might arise from these early informal discussions themselves, before the lawyers are involved. **[1] What are the antitrust risks posed by these early discussions themselves, and how can you manage these risks?**

The VeryBigCo executives told Snoopy that they would be interested in the investment plus loan option only under one condition. They would want the loan tied to a security interest in several of MediumCo's key patents. They know that one of the patents is subject to a dispute and they are willing to accept any risks arising from that dispute. However, they want assurances that if MediumCo goes into bankruptcy, VeryBigCo will walk away with whatever rights in those patents are held by MediumCo. **[2] Do you think it is possible to structure the loan so that VeryBigCo can be sure of getting the patents if MediumCo goes into bankruptcy, and why?**

A few minutes ago, you had a meeting with Snoopy. You thought the two of you would prepare for the next meeting with VeryBigCo, but the conversation with Snoopy took a surprising turn. Snoopy said "I'm going to bring something up at next week's MediumCo's board meeting, and I didn't want to take you by surprise. I've been working with Droopy and Sneezy on a plan for taking the company private through a management buy-out. We have a financial backer. I don't think I should give you any details now – that wouldn't be fair to the other outside directors, but I know they look to you for guidance on this kind of thing. I hope you can explain to them why so many companies are going this route and how sometimes it can be the most sensible course for everyone."

One question you are asking yourself is: **[3] What procedures should you suggest to the board that are typically put in place when a management buy-out is proposed as an alternative to an acquisition by an outsider, to protect the board against allegations of conflicts-of-interest?**

However, apart from the procedures that would typically apply in a management buy-out (MBO), you are starting to worry about a possibly much more serious issue. You are starting to wonder if management has deliberately made the company's performance and prospects look worse than they really are, to drive down the price of the stock which management now wants to purchase. **[4] Given the facts as you understand them, do you think you have significant personal exposure under the securities laws, and what can you do at this point to minimize any exposure that you might have?**