**Discussion Questions # 2: Corporate Acquisitions**

1. Steve runs a company called Orange, which makes computers, phones, and other consumer electronics products. Steve’s goal is to distinguish the company by offering unique features and reliable, high-quality products. He wants to make sure the company’s products look, feel, and really are different. In addition to the hardware, he believes they need to have an operating system and other software that are different from what other companies use.

1. You are Steve’s lawyer. He is considering forming a contract with a software developer, asking them to develop an innovative operating system. He asks you to draft a contract. You ask him to define what he’s looking for and he says, “It has to be unique and innovative.” You ask him to be more specific, and he says, “It has to be really good, creative, and different.”’ What advice do you give him? Is a contract going to be effective in policing the quality standards Steve has in mind?
2. Aside from a contract, do software developers have other (not legally- enforceable) reasons to want to impress Steve?
3. If Steve can’t rely on a contract or on non-legal reasons to ensure that the software is innovative and high quality, what else can Steve do? (Hint: Have you heard the phrase “make or buy decision”?)

2. What is “due diligence”? What problem is it supposed to solve? (Hint: It’s a fundamental theme of this course.) How does a buyer know that a seller is telling the truth when the seller provides information?

3. Carol is an entrepreneur who is developing a cure for the common cold. She would like to sell her company, Seller, to Buyer, a pharmaceutical company. Doug, who works for Buyer, wants to see the clinical trials for the new drug. Carol knows that the results are mixed. They suggest that the drug does cure colds, but they also suggest that the drug may have some serious side-effects.

1. Without any legal constraints, what would Carol (or, indeed, an unethical version of Carol) want to say about the trials? Does she have an incentive to share good news? What about bad news?
2. Can Carol simply share the good news (“the drug cures colds”) but lie about or omit the bad news (serious side-effects)?
3. Does Carol face any legal liability if she simply refuses to share any information about the trials? If Carol refuses, what will Doug assume about the trials?
4. Given your answer to C, do sellers have an incentive to share bad news, as well as good news?
5. In principle, would your answer to “D” change if a seller is able to offer a justification for not to share information, which has nothing to do with the fact that this information might not be flattering?
6. Building on “E,” can you think of a reason why Carol might regret sharing clinical trials with Buyer (even if the trials are glowingly positive) if the deal does not go through? (Hint: Assume that Carol’s company and Buyer are competitors and that the trials contain valuable information.) If so, does this offer Carol a strategy for refusing to disclose the information?
7. If Carol has more than one reason not to disclose the trials, can Buyer tell what the real reason is? What, if anything, can Buyer do in response?

4. Gilson says parties have the incentive to be truthful in due diligence? Do you agree?

5. Seller, a start-up company, is developing a new type of bus, which is supposed to be more fuel efficient. Seller has developed a design, and has made a few of the new buses in order to test them, but has not yet begun delivering buses to customers. New York City has ordered 10,000 of these buses, but no buses have been delivered yet. Buyer is a big company that makes buses, and wants the New York City contract.

Seller has begun testing the buses, and has discovered a problem with the wheels, which may be expensive to fix. Seller has not yet finished testing the buses.

The agreement has the following language: “Buyer has made a lengthy, detailed, and independent investigation regarding the design and specifications of the new bus,” and "Seller has not finished testing the new bus.” The agreement also says that “Seller shall continue to give Buyer access to inspect the new bus” and that "neither party is relying upon any warranty or representation of the other not fully set forth in this agreement." The agreement does not have any other representations about possible defects in the bus or about the tests Seller has been conducting.

After the deal closes and Buyer discovers the defect in the new bus, Buyer sues, claiming that Seller should have told Buyer about the defect.

a. If you are the judge, and you have to decide the case based only on the contract language quoted above, who do you think should win the lawsuit?

b. If you decide that Seller wins, are you rewarding sneakiness?

c. If you decide that Buyer wins, are you rewarding carelessness?

d. What language should Buyer have asked for in the agreement in order to avoid this problem?

7. Carl is the CEO and largest shareholder of a public company, C Brands, which owns a chain of stores and a popular brand of women’s apparel called “D’s Secret.” Sales have been flat or declining for several years. In January 2020, Carl signs a deal in which a private equity firm, Evergreen, agrees to buy 55% of the stock of C Brands. The deal has a “MAC” clause, which specifically carves out “the Covid-19 pandemic,” so Evergreen cannot invoke the Pandemic as a reason to terminate the deal. In the contract, C Brands makes the following commitment: “The seller will continue to operate the business in the ordinary course and will not take any major actions without the prior consent of the buyer.”

1. In response to the Pandemic, most of C Brands’ stores were legally required to close. Carl decides to furlough 1,600 employees, and also stops paying rent on most of the stores. Carl also slashes employee compensation. As you read the language above, do any of these steps give Evergreen the legal right to cancel the deal?
2. Evergreen brings a lawsuit to terminate the deal. Among other reasons, Evergreen alleges that D-Brands has “"drastically [reduced] new merchandise receipts which, when coupled with D-Brands' failure to dispose of existing out-of-season, obsolete and excess merchandise, has saddled the D's Secret Business with a stock of merchandise of greatly diminished value." Based on the contractual language above, do you think this is a winning argument?
3. In bringing a lawsuit, what other motive might Evergreen have aside from trying to terminate the deal?
4. Assuming the MAC clause carves out the Covid pandemic, what other clauses are there in a typical deal that Evergreen can try to use to get out of this deal? (Hint: What is a debt covenant?)

8. “Symmetry” Rationale for MAC clauses: When a seller and a buyer sign a contract, they presumably expect to close the deal in a few weeks or months, but sometimes things change.

1. Why might a seller regret selling and want to cancel the deal?
2. Assume the seller is a public company, and the relevant jurisdiction requires shareholders to vote to approve a deal before the deal can close. If the seller’s business is doing well in the weeks before the shareholder vote, how confident can the buyer be that the deal will close? What if the seller’s business is doing badly?
3. The buyer’s stockholders do not have to vote to approve a deal. Does this put buyers at a disadvantage if conditions change after a deal is signed?
4. Assume that corporate law gives seller’s an advantage over buyers, in affording sellers (but not buyers) ways to back out of a deal if market conditions change. Is there a reason why sellers might want to give up this advantage and “level the playing field”?
5. How could sellers make the playing field more level? What kind of clause could they use? Note that some commentators call this a “symmetry” explanation for the relevant contractual term.
6. Once again, we see the need for contractual (or other) responses to incentive and information problems. What does the term “moral hazard” mean and how does it apply to this issue?

9. Investment Rationale for MAC Clauses: Fran is the CEO of Seller, which owns residential real estate. She signs a deal on July 1 to sell the company to Buyer, which also owns real estate. The deal is scheduled to close on December 31.

1. Fran knows that she is unlikely to stay on after the merger closes. What issue does that create for Buyer?
2. How important is it to continue to maintain the properties and to renew the relevant leases? How motivated is Seller’s management to pursue these goals?
3. What kind of incentive problem are we describing? How could a MAC clause play a role in addressing it? Note that some commentators call this an “investment” explanation for a MAC clause.

10. Assume that an acquisition agreement includes the following definition of a “material adverse change” or “MAC”:

*“Material Adverse Change” shall mean any event change that is materially adverse to the business, assets, or operations of the Company; provided, however, that none of the following shall constitute a Material Adverse Change: changes in the national or world economy or financial markets as a whole or changes in general economic conditions that affect the industries in which the Company conducts business or any change in applicable law, so long as such changes or conditions do not adversely affect the Company in a materially disproportionate manner relative to other similarly situated participants in the industries or markets in which they operate.*

1. Like other MAC clauses, this one has three components. First, it says that a deal can be cancelled if there is a “material adverse change.” Please quote the relevant language.
2. The second component of MAC clauses is a list of exceptions or carve outs, which do not justify a change. Please quote the relevant language.
3. The third component creates “a carve out from the carve out.” Something that otherwise would be excluded can still justify termination of the deal in some circumstances. What are those circumstances? Please quote the relevant language.
4. In the clause above, does the buyer or the seller bear the risk of economic downturns and other general market conditions? Why do you think the risk is allocated in that way?
5. In the clause above, does the buyer or the seller bear the risk of firm-specific problems? Why? Does this allocation of risk make sense?
6. Assume that the language above was used in a deal that closed in October of 2019. Assume the seller is an online retailer that delivers groceries and other products to people’s homes. Assume that the pandemic has increased demand for the seller’s services, but reduced its profitability (because its costs are higher). Under this MAC clause, is the buyer able to back out?
7. The same as “f,” but the seller is an airline that has no local routes and runs only international flights. These routes, connecting the U.S. to Europe and Asia, have all been cancelled. Under this MAC clause, is the buyer able to back out?
8. Assume the seller owns a chain of restaurants across the United States, and assume there is an act of terrorism in Metropolis, a major U.S. city where half of seller’s restaurants are located. In response to the act of terrorism, consumers in Metropolis are more cautious and many stop going to restaurants, but consumers in other cities do not change their behavior. Can the buyer invoke this to get out of the deal?