

**Fall '04**  
**15.616**  
**INNOVATIVE BUSINESSES AND BREAKTHROUGH TECHNOLOGIES -- THE**  
**LEGAL ISSUES**  
John Akula

**FIRST TAKEHOME EXERCISE**

**Period During Which Exercise is Available:**  
Available beginning Tuesday, October 7 at 12 noon;  
To be completed by Thursday, October 9 at 10 pm

**Material Covered:**  
From Class 1 on 9/3 (Akula, "Introduction")  
Through Class 8 on 10/1 (Gordon, "Financing the Venture II")

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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 **three hours** e-mail back to the TA the completed exam. Unless you have made other arrangements with the TA, please place a paper copy of your answer in the TA's Sloan mail folder no later than the next business day after you have completed the exercise. 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.

**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.

## Question 1:

A new venture is being launched by three friends: a radiologist named Dr. Hava Look, a software engineer named Buggy Coder, and a professor of electrical engineering named Knowit All.

The three have an idea about how to improve a magnetic scanner used in medical diagnosis. Their idea is promising. However, none has any business experience, although Knowit has been surfing the Internet recently to learn about management and believes that he now knows enough to set up and run a new venture. On his recommendation, the three have decided to form a corporation, Image Inc.

About a month ago, Dr. Look had the opportunity to get a good price on a used scanner, which the new venture will need, if he acted quickly. Image had not yet been formed, but Dr. Look signed an agreement with the seller under which the used scanner was sold to "Image Inc." for \$30,000, payable in installments over a period of two years. He also hired three men who had done work on his house to move the scanner. There was no written agreement with these men. Unfortunately, they weren't experienced movers and Dr. Look was negligent in the instructions he gave them. As a result of Dr. Look's negligence, one of the movers, who has no health insurance, suffered a ruptured disc in his spine and has been in the hospital ever since.

About two weeks ago, Image Inc. was incorporated. It issued 30,000 shares of stock, and sold 10,000 to each of the founders for one cent per share, so that the company took in \$300. The three founders agreed in writing that, to assure continued commitment to the venture, their stock would vest over three years, with one third vesting at the end of each year. The three also agreed that the company would respect the contract entered into by Dr. Look, and that each of the three would loan Image money as the payments on the scanner became due. That way, the company would not have any assets on hand to be reached by creditors.

- The injured mover has talked to a lawyer about suing for a substantial sum. Does the mover have a good chance of recovering damages from Image? Why? A good chance of recovering from Buggy or Knowit? Why?
- Assume the venture falls apart after three months. The three founders decide to stop loaning Image money, and Image stops making payments on the scanner. Assuming the seller is entitled to damages, does the seller have a good chance of recovering from Buggy or Knowit, and why?
- Assume the venture goes forward. The three founders hope to attract substantial investment within 18 months, and also hope that the value of their stock will climb sharply and stay high until they sell it. In general terms (because you are not expected to have mastered the details of the US tax code), what should they expect to be the tax treatment of any gain on the stock? Is there anything they might do to make the tax treatment more favorable?

## Question II.

Your name is Hot Shot. You have a background in environmental engineering, and, after picking up an MBA from Sloan 5 years ago, you went to work for We Are So Smart (“WASS”), a large consulting firm. At WASS, you got to know a lobbyist named Backroom Bob (“BB”), who did a good job for several WASS clients who had local political concerns. One of your clients, SwampDrainer Inc., became involved in politically sensitive negotiations with local authorities around land-use issues. At your recommendation, SwampDrainer hired BB as its lobbyist and political consultant.

WASS and SwampDrainer both operate in the state of Happy Valley. Elected officials in Happy Valley often hold campaign fundraising dinners. Typically, a ticket to a dinner costs \$100, which is a contribution to that official’s campaign fund. One of the ways BB maintains his political influence is that he helps these officials sell tickets, using his contacts with his clients. Happy Valley has a law against contributions to campaigns by corporations. Violating that law is a criminal offense. But individual executives can buy as many campaign fundraising tickets as they like from their personal funds. BB made it his job to get to know all the top managers at SwampDrainer, and he would occasionally ask some of them to buy a ticket or two to one of the campaign fundraising dinners. After a while, some of the managers began to complain that BB was asking for money just about every month. You had heard about that problem.

You have developed a friendly relationship with SwampDrainer’s CEO, Big Talker. Last weekend, Big Talker invited you over to his house for dinner, and, after a few beers, told you “how that problem with BB always asking managers for money got solved.” A few months ago, SwampDrainer announced a policy that the ten top non-director managers should show up at the beginning of every quarterly board of directors meeting to “be able to answer questions from directors.” Prior to this policy, non-director managers only showed up at a board meeting when specifically invited, which wasn’t a regular practice and rarely involved more than two or three managers. For the extra responsibility of attending each board meeting, each manager is now paid \$300 per meeting. Prior to the new policy, there were no special payments to managers for attending board meetings. When BB goes around to the top managers selling campaign fundraiser tickets, he seems to expect that each manager should buy about one ticket per month, and the managers generally do. As Big Talker said to you after he explained all this, “Pretty damn clever.”

What are the legal risks of this arrangement to WASS and why? What are the risks to you and why? What do you do and why?