

UNIVERSITY OF PENNSYLVANIA

Deals:

The Economic Structure of Transactions and Contracts

LAW 720/MGMT 717

Spring 2021

Mondays and Wednesdays 3:00 to 4:20

At least partly online but if and when in person in Silverman 245A  
University of Pennsylvania Law School

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This course is about the creation of value through transaction and contract design. The goals of the course are to explain how private parties structure and negotiate their commercial interactions, to discuss theories of how they ought to do so, and to give students a thorough understanding of the deal-making process.

The basic idea in the background is that the structuring of transactions and the execution of contracts is informed by a limited number of core economic ideas. The lawyer or banker or other financial services industry professional executing a contract or structuring a transaction can be analogized to a structural engineer, someone whose job it is to choose from a range of possible transactional structures or contractual terms one that is well-suited to the particulars of the situation, that addresses potential stresses or challenges, and that overall seems likely to maximize the total distributable value. Although transactional structures and contractual provisions appear to have almost unlimited possible variation, a small number of core economic issues cause most of the problems and in practice a limited number of basic approaches to addressing them are deployed, and sometimes balanced, in deciding what to do. Accordingly, the aims of this course are to familiarize students with the basic economic issues that impact transactional structures, to teach students how to recognize these issues when they arise, to familiarize students with the generic solutions to these problems, and to learn how to match

existing solutions and problems. In addition, students will learn how to fine tune these generic solutions to specific problems, and more broadly to develop the skills necessary to devise appropriate solutions to apparently new problems.

The first two months will be devoted to discussion of barriers to transacting – including information problems and strategic behavior – and a range of techniques to respond to them as well to other practical aspects of the deal process. In the final five weeks of the course, student teams will apply the tools developed in Part I to a series of recent and particularly interesting completed transactions. This syllabus covers the first of these two parts in detail. The second part will be described once the semester is underway.

Required reading: Course materials on Canvas and in the syllabus plus occasional in-class handouts. For optional background reading on mergers and acquisitions for those interested, Christopher S. Harrison, *Make the Deal: Negotiating Mergers and Acquisitions* (New York: Wiley, 2016) can be had from Amazon or the publisher. (The publisher would, of course, appreciate it if you would buy it directly.)

Grading bases: Class participation (20%); Team’s Part II deal-related responsibilities (team’s class presentation, execution of secondary team role, final version of paper) (40%); Take-home final exam (40%).

Course mechanics and team roles are described in a separate memo.

Please read everything on this syllabus. The cases, newspaper articles, and other materials that are the basis for extended in-class discussion are in **bold**. Please read these materials particularly carefully beforehand and come to class ready to discuss them in depth.

Regular attendance and active class participation is expected.

Note well that this year’s version of the course will be taking place in very unusual circumstances. The public health situation has required some adaptations from the course as we originally had intended to deliver it in 2021A. The two most important of these are that the Part I classes detailed in this syllabus will take place separately for Law and Wharton students (we will reunite for the Part II material—the deals and all related preparatory work) and that there will be some variation in material and delivery between the Law and Wharton Part I sessions. This syllabus gives an accurate account of the basic plans as of November 21, 2021. We may of course have to modify it further as events develop. We will communicate with enrolled students in a timely fashion via email and the most recent syllabus version will always be posted on the course website.

Syllabus:

Some useful background for those who have not yet encountered the ideas

Royal Swedish Academy of Sciences, Press Release 15 October 1985 (Announcement of the Nobel Prize in Economics for 1985). (The key article for our purposes behind the award is not technical in its language and quite thought-provoking. We strongly encourage you to read it if you haven't already. It is Ronald H. Coase, The Nature of the Firm, 4 *Economica* 386-405 (1937).

Royal Swedish Academy of Sciences, Press Release 16 October 1990 (Announcement of the Nobel Prize in Economics for 1990) (For the very curious, see also Franco Modigliani and Merton H. Miller, The Cost of Capital, Corporation Finance, and the Theory of Investment, *American Economic Review* 48(3) (June, 1958) 261- 297.)

Class 0 (Video, view prior to January 20)  
An Introduction to the course

Class 1 (January 20)  
Value Creation through Transaction Design

**Michael S. Knoll and Daniel M.G. Raff, Real Sports Investments and the First Major League Baseball Self-IPO.** (*A minor-league pitcher named Randy Newsom is selling shares of his future earnings. Should you invest?*).

**Michael Klausner, Analysis Research and Reports On the Web (ARROW) exercise.** (*A startup firm is running out of money. There are two offers on the table. Which should the founder/controlling shareholder accept?*)

[NB: More detailed study questions appear at the end of each exercise. Hereafter, just look for study questions at the end of each exercise.]

Class 2 (January 25)  
Value Creation through Organization Design

Adolph Berle and Gardiner Means, The Modern Corporation and Private Property (1932) 119-125.

William A. Sahlman, The Structure and Governance of Venture-Capital Organizations, 27 *Journal of Financial Economics* 473-521 (1990).

**Ronald J. Gilson and Daniel M.G. Raff, Visa exercise.**

Class 3 (January 27)

The Reverse Modigliani-Miller Theorem and an introduction to mergers and acquisition

IBM Closes Landmark Acquisition of Red Hat for \$34 Billion; Defines Open, Hybrid Cloud Future, July 9, 2019.

IBM-Red Hat Merger Agreement October 28, 2018 (Skim Article I).

Michael S. Knoll, The Modigliani-Miller Theorem at 60 The Long-Overlooked Legal Applications of Finance’s Foundational Theorem, 36 Yale Journal on Regulation Bulletin 1-7, 12-17 (2018).

Robert Bruner, Applied Mergers and Acquisitions 531-38.

William J. Carney, Essentials of Mergers and Acquisitions 13-25.

Class 4 (February 1)

Informational Asymmetry: Adverse Selection I

**Michael Klausner, Real Estate Deal with Free Look Clause exercise.**

Class 5 (February 3)

Informational Asymmetry: Adverse Selection II

Gilson, Value Creation by Business Lawyers: Legal Skills and Asset Pricing, 94 Yale Law Journal 239-280 (1984). (Hereafter “Value Creation”).

James Freund, Anatomy of a Merger 242-248 (1975).

IBM-Red Hat Merger Agreement, Article III (Representations and Warranties).

**Michael Klausner, Genre Productions: Pre-arranged Distribution Agreement exercise.**

Grumman v. Rohr 748 F.2d. 729.

Class 6 (February 8)

Agency Costs: Moral Hazard I

IBM-Red Hat Merger Agreement, skim Articles IV, VI, and VII (sections on covenants, closing conditions, termination).

Ward Farnsworth and Eric Posner, Agency, in Ward Farnsworth, The Legal Analyst: A Toolkit for Thinking About the Law 87-93 (2007).

**Michael J. Knoll and Daniel M.G. Raff Proposed Sale of the Illinois Lottery exercise.**

**Michael Klausner, Genre Productions: Movie Financing exercise.**

**Michael Klausner, Genre Productions: Movie Distribution exercise.**

Class 7 (February 10)  
Agency Costs: Moral Hazard II

Ronald J. Gilson Value Creation 280-293.

Ronald J. Gilson and Reiner H. Kraakman, Mechanisms of Market Efficiency, 70 Virginia Law Review 549, 613–621 (1984).

A note on Hotel Management and Ownership.

**Michael Klausner, San Francisco Luxury Hotel Development exercise.**

Class 8 (February 15)

*An Introduction to Contracting Techniques for Dealing with Risk and Uncertainty*

Frank H. Knight, Risk, Uncertainty, and Profit, pages 99-117.

**Ronald J. Gilson, Microvision Corporation Acquisition of Installit, Inc.: Negotiating an Earnout exercise [A] case**

Ronald J. Gilson, Charles F. Sabel, and Robert E. Scott, “Innovation and Contract: Adaptability and Collaboration in an Uncertain World Draft” chapter 1.

Class 9 (February 17)

*MACs, Earnouts, and Information*

Robert J. Gilson and Alan Schwartz, Understanding MACs: Moral Hazard in Acquisitions 2-11, 16-19, 26-29.

**Ronald J. Gilson and Daniel M.G. Raff, Duraflame exercise.**

**Mark Maremont, Buffet Makes \$4.5 Billion Deal with Pritzgers Wall Street Journal December 26, 2007.**

**Raff and Gilson, Roy Vagelos and Oskar Grunwald exercise.**

Class 10 (February 22)

Asset Specificity I

Fountain Manufacturing Agreement between Apple Computer Inc., and SCI Systems, Inc. .

**Indicative Summary of Terms for Secured Loan Facility [to the General Motors Corporation], December 19, 2008.**

**Michael Klausner, Pay or Play and Take or Pay exercises.**

Class 11 (February 24)  
Asset Specificity II

**Ronald J. Gilson, Victor P. Goldberg, and Robert H. Mnookin, Proton Corporation negotiation exercise (NB: Teams will be assigned and materials circulated on February 22<sup>nd</sup>. The exercise should be completed between Class 10 and when we assemble for Class 11.)**

**Michael Klausner and Michael S. Knoll, Miami Dolphins Case Study: Right of First Refusal.**

Class 12 (March 1)  
Taxation I: Introduction

Myron Scholes et al., Taxes and Business Strategy, pages 1-8, 118-27, 130-32.  
Andrew McIntosh, Governor in the Jet-Lease Business, Sacramento Bee, January 3, 2006.

Class 13 (March 3)  
Tax II: Corporate Acquisitions

Materials to be distributed

Class 14 (March 8)  
Tax III: Corporate Dispositions

Materials to be distributed

Class 15 (March 10)  
Loose Ends, Reprise of Part I and a glimpse forward towards the exam,  
and an Introduction to Part II

Material perhaps to be distributed

**NB: CLASS WILL NOT MEET ON MARCH 15 OR MARCH 17**

Classes 17-24 (March 22 through April 21)  
The Deals

Materials to be distributed