Memorandum

To: Students in GSB 42201, Fall, 2004
From: Randy Picker
Re: Mid-Terms
Date: December 2, 2004

Here are some thoughts regarding the substance of the mid-term. For comparability, I have stayed within the same 1500 word limit that you faced. (My answer is 1502 words.)

Question 1

It is important to separate copyright questions from issues of the sort raised by INS v. AP. We obviously had not addressed copyright at the time of the midterm, hence the question’s focus on INS v. AP.

We should consider the costs of production and the extent of ABC’s free-riding. The AP case suggests that “tip” use is permitted free-riding, while just copying the story amounts to unfair competition. We can match that to production costs. Presumably, INS incurred minimal marginal costs in copying stories from the AP, but when the story was just being used as a tip, INS faced substantial costs in independently verifying the story. Although we can’t be sure, the same analysis probably applies here. Even with full information about the Fox show, ABC will incur substantial costs of production in producing its new show. ABC has used the Fox announcement regarding its show as a tip in creating The Curmudgeon.

It is worth considering the recent articulation of the AP rule seen in the Second Circuit’s decision in NBA v. Motorola. That case focuses on whether (i) the plaintiff gathers information at a cost; (ii) the information is time-sensitive; (iii) the defendant is free-riding on the plaintiff’s efforts; (iv) the defendant’s service competes with that offered by plaintiff; and (v) free-riding would “substantially threaten” the plaintiff’s incentives to produce the TV show. Fox undoubtedly spent resources creating the idea for MBFOP, and as discussed above, ABC appears to be free-riding in part on that idea. And both shows are competing for the same audience. But it isn’t at all clear that Fox won’t produce its show even with ABC’s free-riding (and of course in the real world of reality TV, ABC went ahead with Wife Swap even though Fox rushed its copycat show to market first). There is enormous uncertainty for new TV shows: neither may work, both may work, and even if only one works, only a market test will tell us which one. (330 words)
Question 2

We start with the basic contract rules of offer and acceptance. Jane Jones can frame her offer in any way that she likes, so it is perfectly acceptable for her to tell Disney that it can accept the contract through performance (making the movie). ABC Pictures went ahead and made the movie.

But Disney and its subsidiary ABC Pictures, Inc. are separate entities. The recipient of an offer has no power to pass on the offer to another entity. So ABC Pictures could accept the offer from Jones only if we understand “Disney” in the offer to refer to not only the Disney entity, but to the wider Disney enterprise. There are good reasons not to do that. Although $100,000 from ABC Pictures spends just like $100,000 from Disney, a made-for-TV movie is a poor substitute for a major motion picture. All of that means that ABC Pictures should not be able to accept the offer that Jones made to Disney.

Now consider what happens if ABC Pictures sends a check for $100,000 to Jones. The question doesn’t say whether Jones knows that ABC Pictures has made the movie, though it is likely that Jones will put two and two together. We should think of the check as an offer by ABC Picture to Jones regarding her script. The offer isn’t particularly well specified — there could be all sorts of issues that might arise with regard to the script (licensing of action figures, sequels etc.) — but if Jones cashes the check, we should understand her to be accepting a contract with ABC Pictures. We would then be left with trying to fill in the terms of that contract, but the UCC, as an example of contract law, contemplates that we can do that. [293 words]

Question 3

Start with salad dressing and then move to stocks. The claim about the salad dressing market is an example of the unraveling dynamic seen in information economics. Unraveling works most straightforwardly when we have a single-dimension for ranking the information and when statements can be verified so that speakers are punished for false statements. So fat content would be one dimension for salad dressing and could be evaluated after the fact in a consistent fashion (for example, though testing and contrast fat content with “taste”). So smart consumers should be able to make inferences from silence about salad dressing, while less intelligent consumers might not make those inferences.

Now switch to stocks. There are at least two important differences. First, stock markets aggregate information on individual consumers. This was the idea that we saw in Levinson regarding the fraud-on-the-market theory. Put differently, there are informational spillovers in stock markets, and we don’t see those in salad dressing markets. We don’t see information aggregation in the salad dressing market, and when the smart consumer of salad dressing makes his selection, he doesn’t change the market for the less-smart consumer. In contrast, we should expect smart consumers regarding inferences from silence to have a substantial investment advantage relative to less-smart consumers, and the smart
group should push out the less-smart group. Again, we won’t see that dynamic for salad dressing.

The second difference relates to the issue of whether stocks have a single dimension metric that is ex post verifiable (like fat for salad dressing). We might think that that would be profitability, but companies can only forecast profitability and it will be hard to identify after the fact whether a missed forecast was a falsehood or just a mistake. [288 words]

Question 4

The Van Gorkom case describes the “settled rule in Delaware” as that “where a majority of fully informed stockholders ratify action of even interested directors, an attack on the ratified transaction normally must fail.” Gerlach v. Gillam, Del. Ch., 139 A.2d 591 (1958). This suggests that ultimate responsibility for firm decisions rests with the shareholders and the only issue is getting full information to the shareholders (Van Gorkum held that the directors in that case had failed to do just that). This suggests that the direct democracy model would work so long as the board ensured that shareholders received the right package of information.

But we should question the direct democracy model. Taken to the limit, this suggests moving towards direct shareholder voting on many matters. But we might think of the corporation and the board of directors as operating along the lines of the representative democracy we see in the U.S. Congress. This is a model of selecting representatives and delegating decision-making to them. We think this may be especially useful when many shareholders may believe, rationally, that their votes are irrelevant (they will never be the pivotal voter) and hence will not invest in becoming informed about decisions.

We can imagine two quick responses to that idea. First, we need to separate out large institutional shareholders from individual shareholders. The former may be pivotal and would invest accordingly in decision-making. Second, even if we don’t believe in direct democracy for all issues, we might want to identify a core group of issues—perhaps compensation—to make sure that shareholders have paid close attention to what the firm is doing on that issue. [274 words]

Question 5

We should start by calculating the expected value of both projects. For project A, the expected value is 0.5*100 + 0.5*120 = 110. For project B, the expected value is 0.5*60 + 0.5*160 = 110. Both projects have the same expected value; indeed, that was the point. Project B is a mean-preserving spread of Project A: variance increases while the mean remains the same. That quickly means that shareholders would prefer project B to project A, while the Bank has exactly the reverse preferences. And they do: for shareholders, the expected outcome with project A is 0.5*(100-100) + 0.5*(120-100), or $10, reflecting in both cases the fact that the firm can repay the full $100 to Bank (and that has nothing to do with
whether Bank is a secured or unsecured creditor, as the debt obligation of Bank comes before payments can be made to shareholders). For Bank, the expected outcome with project A is $100 (it gets paid in full in both cases). In contrast, for project B, shareholders get $0.5 \times 0 + 0.5 \times (160-100)$, or $30$, while Bank gets $0.5 \times 60 + 0.5 \times 100$, or $80$.

On to solvency and Bank’s rights. The WR Grace case lays out the relevant provisions of the Uniform Fraudulent Transfer Act (UFTA). We are told that under Section 2 of the UFTA, a firm is solvent if its debts exceed its assets. In both cases, prior to running each project, the firm would have a project with an expected value of $110$ and debts of $100$, for a net worth of $10$. Holding project A, Dull is solvent, and just swapping A for B doesn’t change Dull’s net worth: prior to realizing the outcome of either project, Dull will have a net worth of $10$. Unfortunately, the UFTA will probably be of little help to Bank and it will have to hope that it has sufficient covenants in place to block the transfer. [317 words]