

**Law 6060-01  
Business Associations  
Jonathan Klick**

**The Armageddon**

**November 29, 2005  
8:30-12:30  
Room 101**

**This final exam consists of four questions (with three subparts for each question). Each question will be given equal weight in determining your final grade.**

**This is an open book and open note exam. You may use your casebook, class notes, casebook supplements, commercial outlines, commercial supplements, lucky charms, and any other printed or written materials you believe will be helpful in completing your answers.**

**You will be given four hours to complete this exam, and you may allocate your time among the questions as you see fit. There is no answer sheet for this exam. You may write/type as long or as short an answer as you believe is necessary to completely answer the test questions. If you need extra bluebooks, please quietly request them from the proctor. If you finish early, please submit your bluebooks or computer disks to the exam proctor and quietly exit the room.**

**If you perceive an ambiguity or error in any test question, please proceed to answer it, noting the ambiguity/error and making any reasonable assumptions you believe are necessary to answer the question. Please state these assumptions in your answer and provide your justification for the assumption.**

**Since some students have arranged to take the exam at a later date, recognize that any information you provide them about the exam will adversely affect your own grade because of the law school's grading curve.**

**Good luck and have a nice break.**

1. On October 6, 2004, the self-described “King of All Media” Howard Stern publicly announced that he was leaving the company (Viacom) that syndicates his morning drive time radio show at the end of 2005 to begin broadcasting his show on the Sirius Satellite Radio Network on January 1, 2006. The terms of the deal include a payment to Stern on the order of \$100 million per year for five years. For Sirius to break even in the deal (and presumably continue it beyond the initial five year run) Stern needs to lure an additional one million subscribers to Sirius (roughly a 10 percent increase in its subscriber base). At the time, many analysts suggested that if Stern is successful in bringing a large market to satellite radio, it will bring viability to the entire satellite radio industry (which includes Sirius and its competitor XM Satellite Radio).

In the interim, Stern has fulfilled his contractual obligations by continuing his Viacom-syndicated show. During the course of the year, Stern continually discussed the preparations for his Sirius show on his Viacom broadcast and suggested that his millions of loyal fans subscribe to Sirius Satellite Radio immediately so as to be ready when the new show takes the air, while suggesting that conventional radio stations, including those owned by Viacom and companies that pay to broadcast Stern’s program, provide a low quality product. He also awarded Sirius radio equipment as prizes during his on-air contests. This “advertising” appears to have been effective as thousands of Stern fans subscribed to Sirius over the course of the year. Additionally, Stern’s ratings fell significantly in many markets across the country, including a 33% drop in the nation’s #3 media market (Washington, DC) and a 15% drop in his home market of New York City. When Viacom officials chastised him for spending so much time promoting his new show on air, Stern pointed out that his contract with Viacom explicitly states that Viacom can not restrict the content of his show, as long as he stays within the regulatory bounds set by the Federal Communications Commission. As he has done for much of his career, Stern publicly (i.e., on his show and in the press) casts his employer’s attempts to influence the content of his show as censorship, generating significant attention and sympathy for him among his listeners.

For the purposes of this question, assume Viacom’s 12-person Board of Directors is composed of Sumner Redstone and his daughter Shari Redstone. Sumner has large equity holdings in various non-Viacom media companies, including XM Satellite Radio. Another member of Viacom’s board is an employee of Oppenheimer Funds, which has substantial holdings in Sirius. Another board member is the former Commissioner of the Federal Communications Commission, which has levied millions of dollars in fines against Howard Stern for indecency on the airwaves. Another board member is also an agent who represents a number of clients with satellite radio connections, such as Eminem (who programs a channel on Sirius) and Snoop Dogg (who programs a channel on XM). Another board member is James Dobson, who heads the interest group Focus on the Family, which has, in the past, organized boycotts of firms that advertise on the Howard Stern show,

due to the offensive content of his program. Mel Karmazin, a former Viacom executive and current president of Sirius, is also on the board of Viacom. The remaining 5 directors have had no personal or business relationship with Stern or any firm in the satellite radio industry.

Assume that Viacom is incorporated in Delaware, and Delaware law governs all claims related to Viacom.

**1.a Assume you are a plaintiff's lawyer who is approached by a Viacom shareholder who is angered by what Stern has done on his Viacom show since announcing his Sirius deal and wants to sue Stern for damages. How would you construct your claim against Stern?**

**1.b Procedurally, what do you need to do to bring this case against Stern?**

**1.c Now assume that you are an in-house counsel for Viacom, and the board asks you whether it should litigate against Stern. What issues should you consider and why?**

2. The Efficient Markets Hypothesis and the Law

**2a. Explain the efficient markets hypothesis and distinguish among the forms of the hypothesis.**

**2b. Upon which form of the efficient markets hypothesis does the “fraud on the market” theory of reliance depend and why?**

**2c. In what ways do current corporate and securities laws make financial markets more informationally efficient and why? In what ways do current corporate and securities laws make financial markets less informationally efficient and why? [Note: more and less should be defined in terms of the counterfactual in which the law you are discussing does not exist]**

3. According to Ronald Coase's 1937 article "The Nature of the Firm," firms exist to minimize the sum of transactions costs and agency costs. In his explanation of what that means, Coase argues that sometimes it is less expensive to internalize transactions within a firm than it is to "discover" the relevant price [and contract for the desired terms] in the market. However, beyond some point, these cost savings are offset by increasing agency costs (e.g., Coase clearly does not believe that total costs could be minimized through the creation of a Soviet-style national central planning authority).

**3.a The modern economy, in many ways, looks quite a bit different from the economy Coase studied. In particular, changes in technology have presumably affected both agency costs and transactions costs. Discuss changes that might have the effect of making the optimal firm in today's economy larger [in size/scope] than the firms Coase examined in the early 1930s.**

**3.b Discuss changes that might have the effect of making the optimal firm in today's economy smaller [in size/scope] than the firms Coase examined in the early 1930s.**

**3.c. One way to mitigate agency costs in a corporation is to tie a manager's compensation to firm performance. Discuss the relative merits/downsides of the following ways to compensate a manager: i) Bonuses tied to annual firm profits or profit sharing; ii) Awarding stock or stock options (calls); iii) Stock/stock options with sales restrictions (e.g., award stock now, but restrict the manager from selling the stock for 5 years); iv) Indexed stock (i.e., some form of derivative security that only has value when the manager's firm outperforms either the market in general or some well-defined portfolio of other firms in the manager's industry. For example, if stocks of other firms in the manager's industry appreciate 10 percent during the year on average, the manager's "stock" only has value if his firm's stock appreciates more than 10 percent. Conversely, if the other firms lose 10 percent in share value, the manager's "stock" has some value as long as his firm's stock loses less than 10 percent of its value).**

4. Mr. D. O. Gooder is the owner of a small software company, Boring Games, that focuses on designing and selling family friendly games that include no elements of sex, violence, or foul language. Boring Games has invested the last of its internal funds on creating and marketing its new adventure game, *Sunday Drive*, as a competitor to the best-selling video game *Grand Theft Auto III* (GTA). Gooder believes that *Sunday Drive* could displace GTA as the top selling game if only Boring Games had access to additional capital to mount a nation-wide marketing campaign. In addition to his entrepreneurial objectives, Gooder also wants *Sunday Drive* to succeed because he believes that GTA is corrupting youth across the country due to its violent and sexual themes.

Gooder, unsatisfied in the progress he has made in his crusade against GTA, decides to mount an attack from within. Through his Internet trading account, he purchases 100 shares of Take-Two Interactive Software, Inc., whose wholly-owned subsidiary Rockstar Games produces GTA (GTA accounts for 50 percent of Rockstar Games annual revenues and Rockstar Games accounts for 8 percent of Take-Two's annual revenue). Mr. Gooder intends to offer a resolution at Take-Two's annual meeting that the company stop distributing GTA, and that it also undertake a national advertising campaign denouncing violent and/or sexually explicit video games. To that end, he requests that Take-Two's board include his resolution and a supporting statement in the firm's proxy statement. He also requests that the firm give him its shareholder list, because he intends to mail copies of studies that show games like GTA lead to juvenile delinquency.

**4.a You are an attorney advising Take-Two's board. What do you recommend it do with respect to Mr. Gooder's request to have his statement included in the proxy statement and why?**

**4.b What do you recommend with respect to his request for the shareholder list and why?**

**4.c What if his proxy proposal does not suggest the discontinuation of GTA or the advertising campaign, but merely proposes that Rockstar Games fires the programmers who secretly embedded especially explicit scenes in GTA (the scenes could be unlocked with special keys available on the Internet)? Does your answer to 4.a change at all? Why or why not?**