Chapter 17
Mergers, LBOs, Divestitures, and Business Failure

■ Learning Goals

1. Understand merger fundamentals, including terminology, motives for merging, and types of mergers.
2. Describe the objectives and procedures used in leveraged buyouts (LBOs) and divestitures.
3. Demonstrate the procedures used to value the target company, and discuss the effect of stock swap transactions on earnings per share.
4. Discuss the merger negotiation process, holding companies, and international mergers.
5. Understand the types and major causes of business failure and the use of voluntary settlements to sustain or liquidate the failed firm.
6. Explain bankruptcy legislation and the procedures involved in reorganizing or liquidating a bankrupt firm.

■ True/False

1. A merger occurs when two or more firms are combined to form a completely new corporation.

   Answer: FALSE
   Level of Difficulty: 1
   Learning Goal: 1
   Topic: Merger Basics

2. The overriding goal for merging is the maximization of the owners' wealth as reflected in the acquirer's share price.

   Answer: TRUE
   Level of Difficulty: 1
   Learning Goal: 1
   Topic: Merger Motives

3. Firms' motives to merge include growth or diversification, synergy, fundraising, tax considerations, and defense against takeover.

   Answer: TRUE
   Level of Difficulty: 1
   Learning Goal: 1
   Topic: Merger Motives

4. A conglomerate merger is a merger combining firms in unrelated businesses.

   Answer: TRUE
   Level of Difficulty: 1
   Learning Goal: 1
   Topic: Conglomerate Mergers

5. A congeneric merger is a merger combining firms in unrelated businesses.

   Answer: FALSE
   Level of Difficulty: 1
   Learning Goal: 1
   Topic: Congeneric Mergers

6. Greater control over the acquisition of new materials or the distribution of finished goods is an economic benefit of horizontal merger.

   Answer: FALSE
   Level of Difficulty: 1
   Learning Goal: 1
   Topic: Horizontal Mergers

7. Vertical merger may result in expansion of operations in an existing product line and elimination of a competitor.

   Answer: FALSE
   Level of Difficulty: 1
   Learning Goal: 1
   Topic: Vertical Mergers

8. Consolidation involves the combination of two or more firms, and the resulting firm maintains the identity of one of the firms.

   Answer: FALSE
   Level of Difficulty: 1
   Learning Goal: 1
   Topic: Consolidations

9. The companies controlled by a holding company are normally referred to as its subsidiaries.

   Answer: TRUE
   Level of Difficulty: 1
   Learning Goal: 1
   Topic: Holding Companies

10. The takeover target's management may not support a proposed takeover due to a very high tender offer.

    Answer: FALSE
    Level of Difficulty: 1
    Learning Goal: 1
    Topic: Target Firms

11. A vertical merger is a merger of two firms in the same line of business.

    Answer: FALSE
    Level of Difficulty: 1
    Learning Goal: 1
    Topic: Vertical Mergers

12. A horizontal merger is a merger in which one firm acquires another firm in the same general industry but neither in the same line of business nor a supplier or customer.

    Answer: FALSE
    Level of Difficulty: 1
    Learning Goal: 1
    Topic: Horizontal Mergers

13. A congeneric merger is a merger in which a firm acquires a supplier or a customer.

    Answer: FALSE
    Level of Difficulty: 1
    Learning Goal: 1
    Topic: Congeneric Mergers

14. Tender offer is a formal offer to purchase a given number of shares of a firm's stock at a specified price.

    Answer: TRUE
    Level of Difficulty: 1
    Learning Goal: 1
    Topic: Tender Offers

15. Strategic mergers seek to achieve various economies of scale by eliminating redundant functions, increasing market share, and improving raw material sourcing and finished product distribution.

    Answer: TRUE
    Level of Difficulty: 2
    Learning Goal: 1
    Topic: Strategic Mergers

16. An operating merger occurs when the operations of the acquiring and target firms are combined in order to achieve economies and thereby cause the performance of the merged firm to exceed that of the pre-merged firm.

    Answer: FALSE
    Level of Difficulty: 2
    Learning Goal: 1
    Topic: Operating Mergers

17. A holding company is a corporation which is controlled by one or more other corporations.

    Answer: FALSE
    Level of Difficulty: 2
    Learning Goal: 1
    Topic: Holding Companies

18. Financial mergers involve merging firms in order to achieve various economies of scale by eliminating redundant functions, increasing market share, and improving raw material sourcing and finished product distribution.

    Answer: FALSE
    Level of Difficulty: 2
    Learning Goal: 1
    Topic: Financial Mergers

19. A consolidation is a corporation that has voting control of one or more other corporations.

    Answer: FALSE
    Level of Difficulty: 2
    Learning Goal: 1
    Topic: Consolidations

20. Financial merger is a merger transaction undertaken to achieve economies of scale.

    Answer: FALSE
    Level of Difficulty: 2
    Learning Goal: 1
    Topic: Financial Mergers

21. Strategic merger is a merger transaction undertaken with the goal of restructuring the acquired company in order to improve its cash flow and unlock its hidden value.

    Answer: FALSE
    Level of Difficulty: 2
    Learning Goal: 1
    Topic: Strategic Mergers

22. The synergy of mergers is the economies of scale resulting from the merged firms' lower overhead.

    Answer: TRUE
    Level of Difficulty: 2
    Learning Goal: 1
    Topic: Synergy of Mergers

23. The tax loss carryforward benefits can be used in mergers but cannot be used in the formation of holding companies.

    Answer: TRUE
    Level of Difficulty: 2
    Learning Goal: 1
    Topic: Tax Loss Carryback and Carryforward

24. LBOs are an example of a financial merger undertaken to create a high-debt private corporation with improved cash flow and value.

    Answer: TRUE
    Level of Difficulty: 1
    Learning Goal: 2
    Topic: Leveraged Buyout Basics

25. An attractive candidate for acquisition through leveraged buyout must have a good position in its industry with a solid profit history and reasonable expectation for growth.

    Answer: TRUE
    Level of Difficulty: 1
    Learning Goal: 2
    Topic: Leveraged Buyout Candidates

26. An attractive candidate for acquisition through leveraged buyout usually has a relatively high level of debt and a low level of "bankable" assets.

    Answer: FALSE
    Level of Difficulty: 1
    Learning Goal: 2
    Topic: Leveraged Buyout Candidates

27. The motive for divestiture is often to get rid of a product line in order to generate cash for expansion of other product lines.

    Answer: TRUE
    Level of Difficulty: 1
    Learning Goal: 2
    Topic: Motives for Divestitures

28. The selling of some of a firm's assets for various strategic motives is called divestiture.

    Answer: TRUE
    Level of Difficulty: 1
    Learning Goal: 2
    Topic: Motives for Divestitures

29. A spin-off is a form of divestiture in which an operating unit becomes an independent company by issuing shares in it on a pro rata basis to the parent company's shareholders.

    Answer: TRUE
    Level of Difficulty: 2
    Learning Goal: 2
    Topic: Spin-Offs

30. The sale of a unit of a firm to existing management is often achieved through a leveraged buyout.

    Answer: TRUE
    Level of Difficulty: 2
    Learning Goal: 2
    Topic: Leveraged Buyouts

31. A firm that wants to expand or extend its operations in existing or new product areas may avoid many of the risks associated with the design, manufacture, and sale of additional or new product and remove a potential competitor by acquiring a suitable going concern.

    Answer: TRUE
    Level of Difficulty: 1
    Learning Goal: 3
    Topic: Motives for Acquisitions

32. The basic difficulty in applying the capital budgeting approach to the acquisition of a going concern is the estimation of initial cash flows and certain risk consideration.

    Answer: FALSE
    Level of Difficulty: 1
    Learning Goal: 3
    Topic: Analyzing Acquisitions

33. Stock swap transaction is an acquisition method in which the acquiring firm exchanges its shares for shares of the target company according to a predetermined ratio.

    Answer: TRUE
    Level of Difficulty: 1
    Learning Goal: 3
    Topic: Stock Swap Transactions

34. Ratio of exchange in market price indicates the market price per share of the acquiring firm paid for each dollar of market price per share of the target firm.

    Answer: TRUE
    Level of Difficulty: 2
    Learning Goal: 3
    Topic: Ratio of Exchange and Acquisitions

35. The actual ratio of exchange in a stock-exchange acquisition is the ratio of the amount paid per share of the target company to the per-share market price of the acquiring firm.

    Answer: TRUE
    Level of Difficulty: 2
    Learning Goal: 3
    Topic: Ratio of Exchange and Acquisitions

36. The earnings per share of the merged firm are generally above the premerger earnings per share of one firm and below the premerger earnings per share of the other, after making the necessary adjustment for the ratio of exchange.

    Answer: TRUE
    Level of Difficulty: 3
    Learning Goal: 3
    Topic: Ratio of Exchange and Acquisitions

37. If the P/E paid is greater than the P/E of the acquiring company, on a postmerger basis the target firm's EPS increases and the acquiring firm's EPS decreases.

    Answer: TRUE
    Level of Difficulty: 3
    Learning Goal: 3
    Topic: P/E Ratio and Mergers

38. The owners of a holding company can control significantly larger amounts of assets than they could acquire through mergers.

    Answer: TRUE
    Level of Difficulty: 1
    Learning Goal: 4
    Topic: Holding Company Basics

39. The owners of a holding company can control significantly larger amounts of assets than they could acquire through mergers.

    Answer: TRUE
    Level of Difficulty: 1
    Learning Goal: 4
    Topic: Holding Company Basics

40. A major disadvantage of holding companies is the increased risk resulting from the leverage effect.

    Answer: TRUE
    Level of Difficulty: 2
    Learning Goal: 4
    Topic: Disadvantages of Holding Companies

41. Two-tier offer is a tender offer in which the terms offered are more attractive to those who tender shares early.

    Answer: TRUE
    Level of Difficulty: 2
    Learning Goal: 4
    Topic: Two-Tier Offers

42. White knight is a takeover defense in which a firm issues securities that give their holders certain rights that become effective when a takeover is attempted and that make the target firm less desirable to a hostile acquirer.

    Answer: FALSE
    Level of Difficulty: 3
    Learning Goal: 4
    Topic: White Knight Takeover Defense

43. Poison pill is a takeover defense in which the target firm finds an acquirer more to its liking than the initial hostile acquirer and prompts the two to compete to take over the firm.

    Answer: FALSE
    Level of Difficulty: 3
    Learning Goal: 4
    Topic: Poison Pills Takeover Defense

44. Greenmail is a takeover defense under which the target firm repurchases a large block of stock at a premium from one or more shareholders in order to end a hostile takeover attempt by those shareholders.

    Answer: TRUE
    Level of Difficulty: 3
    Learning Goal: 4
    Topic: Greenmail Takeover Defense

45. Pyramiding is an arrangement among holding companies wherein one company controls others, thereby causing an even greater magnification of earnings and losses.

    Answer: TRUE
    Level of Difficulty: 3
    Learning Goal: 4
    Topic: Pyramiding and Holding Companies

46. Technical insolvency occurs when a firm's liabilities exceed the fair market value of its assets.

    Answer: FALSE
    Level of Difficulty: 1
    Learning Goal: 5
    Topic: Technical Insolvency

47. In a voluntary settlement, composition is an arrangement in which the creditor committee replaces the firm's operating management and operates the firm until all claims have been settled.

    Answer: FALSE
    Level of Difficulty: 2
    Learning Goal: 5
    Topic: Voluntary Settlements

48. Chapter 7 of the Bankruptcy Reform Act of 1978 outlines the procedures for reorganizing a failed (or failing) firm, whether its petition is filed voluntarily or involuntarily.

    Answer: FALSE
    Level of Difficulty: 2
    Learning Goal: 6
    Topic: Chapter 7 Bankruptcy

49. Under recapitalization, debts are generally exchanged for equity or the maturities of existing debts are extended.

    Answer: TRUE
    Level of Difficulty: 3
    Learning Goal: 6
    Topic: Recapitalization

50. One of the responsibilities of the Debtor in Possession (DIP) is the liquidation of the firm's assets.

    Answer: FALSE
    Level of Difficulty: 3
    Learning Goal: 6
    Topic: Debtor in Possession

51. In the broadest sense, activities involving expansion or contraction of a firm's operations or changes in its assets or ownership structure are called corporate restructuring.

    Answer: TRUE
    Level of Difficulty: 1
    Learning Goal: 1
    Topic: Corporate Restructuring

52. In the broadest sense, activities involving expansion or contraction of a firm's operations or changes in its assets or ownership structure are called corporate maneuvering.

    Answer: FALSE
    Level of Difficulty: 1
    Learning Goal: 1
    Topic: Corporate Restructuring

53. Holding companies simply are corporations that have voting control of one or more other corporations and the companies they control are often referred to as subsidiaries.

Answer: TRUE
Level of Difficulty: 1
Learning Goal: 1
Topic: Holding Companies

54. Subsidiary companies simply are corporations that have voting control of one or more other corporations and the companies they control are often referred to as holding companies.

Answer: FALSE
Level of Difficulty: 1
Learning Goal: 1
Topic: Holding Companies

55. Primary motives for merging include growth or diversification, synergy, fund raising, increased managerial skill or technology, tax considerations, increased ownership liquidity, and defense against takeovers.

Answer: TRUE
Level of Difficulty: 2
Learning Goal: 1
Topic: Motives for Mergers

56. Primary motives for merging include growth or diversification, synergy, fund raising, increased managerial skill or technology, tax considerations, increased ownership liquidity, and acquiring new upper-level management personnel.

Answer: FALSE
Level of Difficulty: 2
Learning Goal: 1
Topic: Motives for Mergers

57. It is not unusual for acquirers in LBOs to be members of the firm's existing management team.

Answer: TRUE
Level of Difficulty: 1
Learning Goal: 2
Topic: Acquirers in LBOs

58. One of the key attributes that makes a firm a good candidate for an LBO is that it has stable and predictable cash flows that are adequate to meet interest and principal payments on the debt and provide adequate working capital.

Answer: TRUE
Level of Difficulty: 2
Learning Goal: 2
Topic: Key Attributes of LBO Candidates

59. One of the key attributes that makes a firm a good candidate for an LBO is that it has a relatively low level of debt and a high level of relatively liquid assets that could be used as loan collateral.

    Answer: TRUE
    Level of Difficulty: 2
    Learning Goal: 2
    Topic: Key Attributes of LBO Candidates

60. One of the key attributes that makes a firm a good candidate for an LBO is that it has a relatively high level of debt and a low level of relatively liquid assets that could be used as loan collateral.

    Answer: FALSE
    Level of Difficulty: 2
    Learning Goal: 2
    Topic: Key Attributes of LBO Candidates

61. One of the key attributes that makes a firm a good candidate for an LBO is that it has a solid position in the industry with reasonable expectations for future growth.

    Answer: TRUE
    Level of Difficulty: 2
    Learning Goal: 2
    Topic: Key Attributes of LBO Candidates

62. Unlike business bankruptcy and business failure, divestiture is often undertaken for positive motives such as to generate cash for the expansion of product lines, to get rid of poorly performing operations, to streamline the company, or to restructure the business that is consistent with the firm's strategic goals.

    Answer: TRUE
    Level of Difficulty: 2
    Learning Goal: 2
    Topic: Divestitures

63. Like business bankruptcy and business failure, divestiture is most often undertaken to relieve pressure by creditors such as bondholders and banks due to the firm's relatively high debt levels.

    Answer: FALSE
    Level of Difficulty: 2
    Learning Goal: 2
    Topic: Divestitures

64. Methods of divestiture include the sale of a product line to another firm, the sale of a unit to existing management, spin-offs, and the liquidation of assets.

    Answer: TRUE
    Level of Difficulty: 2
    Learning Goal: 2
    Topic: Methods of Divesting

65. Methods of divestiture include the sale of a product line to another firm, the sale of a unit to existing management, the donation of a unit to a charity, and the liquidation of assets.

Answer: FALSE
Level of Difficulty: 2
Learning Goal: 2
Topic: Methods of Divesting

66. The value of a firm measured as the sum of the values of its operating units if each were sold separately is known as a firm's part and parcel value.

Answer: FALSE
Level of Difficulty: 2
Learning Goal: 2
Topic: Breakup Value in Divestitures

67. The value of a firm measured as the sum of the values of its operating units if each were sold separately is known as a firm's breakup value.

Answer: TRUE
Level of Difficulty: 2
Learning Goal: 2
Topic: Breakup Value in Divestitures

68. A method of acquisition in which the acquiring firm exchanges its shares of stock for shares of the target company according to a predetermined ratio is called a stock swap transaction.

Answer: TRUE
Level of Difficulty: 2
Learning Goal: 3
Topic: Stock Swap Transactions in Acquisitions

69. A method of acquisition in which the acquiring firm exchanges its shares of stock for shares of the target company according to a predetermined ratio is called a leveraged buyout.

Answer: FALSE
Level of Difficulty: 2
Learning Goal: 3
Topic: Stock Swap Transactions in Acquisitions

70. Acquisitions are especially attractive when the acquired firm's stock price is high, because fewer shares must be exchanged to acquire the firm.

Answer: FALSE
Level of Difficulty: 2
Learning Goal: 3
Topic: Acquisitions

71. Acquisitions are especially attractive when the acquiring firm's stock price is high, because fewer shares must be exchanged to acquire the firm.

Answer: TRUE
Level of Difficulty: 2
Learning Goal: 3
Topic: Acquisitions

72. Popular takeover defense methods include white knights, poison pills, greenmail, golden parachutes, and shark repellents.

    Answer: TRUE
    Level of Difficulty: 2
    Learning Goal: 4
    Topic: Takeover Defenses

73. Popular takeover defense methods include white knights, poison pills, greenmail, financial sabotage, and shark repellents.

    Answer: FALSE
    Level of Difficulty: 2
    Learning Goal: 4
    Topic: Takeover Defenses

74. The U.S. approaches used in hostile takeovers is an affective method of changing corporate control and used in many areas of the world including Great Britain, China, and Japan.

    Answer: FALSE
    Level of Difficulty: 2
    Learning Goal: 4
    Topic: International Mergers

75. The U.S. approaches used in hostile takeovers is practically nonexistent in most other countries throughout the world including continental Europe and Asia.

    Answer: TRUE
    Level of Difficulty: 2
    Learning Goal: 4
    Topic: International Mergers

76. The primary causes of business failure are mismanagement, poor economic conditions, and corporate maturity.

    Answer: TRUE
    Level of Difficulty: 2
    Learning Goal: 5
    Topic: International Mergers

77. The primary causes of business failure are inventory mismanagement, poor marketing campaigns, and corporate theft.

    Answer: FALSE
    Level of Difficulty: 2
    Learning Goal: 5
    Topic: International Mergers

78. The debtor in possession in a Chapter 11 bankruptcy proceeding is responsible for valuing the firm both in terms of its liquidation value and as a going concern.

    Answer: TRUE
    Level of Difficulty: 2
    Learning Goal: 6
    Topic: Chapter 11 Bankruptcy

79. The creditor in possession in a Chapter 12 bankruptcy proceeding is responsible for valuing the firm both in terms of its liquidation value and as a going concern.

    Answer: FALSE
    Level of Difficulty: 2
    Learning Goal: 6
    Topic: Chapter 11 Bankruptcy

80. In a Chapter 7 liquidation bankruptcy proceeding, the order of priority of satisfying claims is secured creditors, unsecured creditors, and then equity holders.

    Answer: TRUE
    Level of Difficulty: 2
    Learning Goal: 6
    Topic: Chapter 7 Bankruptcy

■ Multiple Choice Questions

1. Business combinations are used by firms to externally expand in order to achieve all of the following objectives EXCEPT

   (a) to increase productive capacity.
   (b) to increase liquidity.
   (c) to increase common stock outstanding.
   (d) to acquire needed assets.

   Answer: C
   Level of Difficulty: 1
   Learning Goal: 1
   Topic: Motives for Business Combinations

2. Common forms of business combination include all of the following EXCEPT

   (a) congeneric formation.
   (b) consolidations.
   (c) mergers.
   (d) holding companies.

   Answer: A
   Level of Difficulty: 1
   Learning Goal: 1
   Topic: Forms of Business Combinations

3. The combination of two or more companies to form a completely new corporation is a

   (a) congeneric formation.
   (b) consolidation.
   (c) merger.
   (d) holding company.

   Answer: B
   Level of Difficulty: 1
   Learning Goal: 1
   Topic: Consolidations

4. A combination of companies where the former corporations cease to exist is
   (a) a congeneric formation.
   (b) a consolidation.
   (c) a merger.
   (d) a holding company.

   Answer: B
   Level of Difficulty: 1
   Learning Goal: 1
   Topic: Consolidations

5. The combination of two or more companies which results in the firm maintaining the identity of one of the firms is
   (a) congeneric formation.
   (b) consolidation.
   (c) merger.
   (d) holding company.

   Answer: C
   Level of Difficulty: 1
   Learning Goal: 1
   Topic: Mergers

6. The firm in a merger transaction that attempts to merge or takeover another company is called the
   (a) target company.
   (b) holding company.
   (c) acquiring company.
   (d) conglomerate.

   Answer: C
   Level of Difficulty: 1
   Learning Goal: 1
   Topic: Acquiring Company

7. The firm in a merger transaction that is being pursued as a takeover potential is called the
   (a) acquiring company.
   (b) target company.
   (c) holding company.
   (d) conglomerate.

   Answer: B
   Level of Difficulty: 1
   Learning Goal: 1
   Topic: Target Company

8. The combination of two or more companies which results in one of the corporations having a voting control of one or more of the other companies is a
   (a) congeneric formation.
   (b) consolidation.
   (c) merger.
   (d) holding company.

   Answer: D
   Level of Difficulty: 1
   Learning Goal: 1
   Topic: Acquiring Company

9. _________ results from the combination of firms in the same line of business.
   (a) Congeneric growth
   (b) Conglomerate diversification
   (c) Horizontal growth
   (d) Vertical growth

   Answer: C
   Level of Difficulty: 1
   Learning Goal: 1
   Topic: Horizontal Growth

10. _________ results when a firm acquires a supplier or a customer.
   (a) Congeneric merger
   (b) Conglomerate merger
   (c) Horizontal merger
   (d) Vertical merger

   Answer: D
   Level of Difficulty: 1
   Learning Goal: 1
   Topic: Vertical Mergers

11. _________ involves the combination of firms in unrelated businesses.
   (a) Congeneric merger
   (b) Conglomerate merger
   (c) Horizontal merger
   (d) Vertical merger

   Answer: B
   Level of Difficulty: 1
   Learning Goal: 1
   Topic: Conglomerate Mergers

12. Generally, a combination of two firms of unequal size is called
    (a) a congeneric formation.
    (b) a consolidation.
    (c) a merger.
    (d) a holding company.

    Answer: C
    Level of Difficulty: 1
    Learning Goal: 1
    Topic: Mergers

13. Most firms seeking merger partners will hire the services of
    (a) a commercial banker.
    (b) an investment broker.
    (c) a private contractor.
    (d) an investment banker.

    Answer: D
    Level of Difficulty: 1
    Learning Goal: 1
    Topic: Investment Bankers Role in Mergers

14. The combination of a dress manufacturer and a credit bureau is an example of
    (a) congeneric merger.
    (b) conglomerate merger.
    (c) horizontal merger.
    (d) vertical merger.

    Answer: B
    Level of Difficulty: 2
    Learning Goal: 1
    Topic: Conglomerate Mergers

15. Greater control over the acquisition of raw materials or the distribution of finished goods is an economic benefit of
    (a) congeneric merger.
    (b) conglomerate merger.
    (c) horizontal merger.
    (d) vertical merger.

    Answer: D
    Level of Difficulty: 2
    Learning Goal: 1
    Topic: Vertical Mergers

16. _________ may result in expansion of operations in an existing product line and elimination of a competitor.
    (a) Congeneric merger
    (b) Conglomerate merger
    (c) Horizontal merger
    (d) Vertical merger

    Answer: C
    Level of Difficulty: 2
    Learning Goal: 1
    Topic: Horizontal Mergers

17. Typically, reasons for undertaking mergers are
    (a) only financial.
    (b) only strategic.
    (c) strategic or financial.
    (d) in conflict with wealth maximization.

    Answer: C
    Level of Difficulty: 2
    Learning Goal: 1
    Topic: Motives for Mergers

18. When a firm undertakes a merger in order to eliminate redundant functions or increase market share, this is an example of
    (a) financial merger.
    (b) hostile takeover.
    (c) friendly merger.
    (d) strategic merger.

    Answer: D
    Level of Difficulty: 2
    Learning Goal: 1
    Topic: Strategic Mergers

19. When a firm undertakes a merger to improve its sources and supply of raw materials, this is an example of a
    (a) financial merger.
    (b) hostile takeover.
    (c) friendly merger.
    (d) strategic merger.

    Answer: D
    Level of Difficulty: 2
    Learning Goal: 1
    Topic: Strategic Mergers

20. _________ is achieved by acquiring a company in the same general industry, but neither in the same line of business nor a supplier or a customer.
    (a) Congeneric merger
    (b) Conglomerate merger
    (c) Horizontal merger
    (d) Vertical merger

    Answer: A
    Level of Difficulty: 2
    Learning Goal: 1
    Topic: Congeneric Mergers

21. The ability to use the same sales and distribution channels to reach customers of both businesses is a benefit of
    (a) congeneric merger.
    (b) conglomerate merger.
    (c) horizontal merger.
    (d) vertical merger.

    Answer: A
    Level of Difficulty: 2
    Learning Goal: 1
    Topic: Congeneric Mergers

22. One of the key motives for combinations is the tax benefit of
    (a) reducing the marginal tax rate.
    (b) taking advantage of the other firm's tax loss carryforward.
    (c) using capital gains.
    (d) increasing additional recaptured depreciation.

    Answer: B
    Level of Difficulty: 2
    Learning Goal: 1
    Topic: Motives for Combinations

23. All of the following are reasons for mergers EXCEPT
    (a) increasing managerial skills.
    (b) tax considerations.
    (c) synergism.
    (d) monopoly control of the markets.

    Answer: D
    Level of Difficulty: 2
    Learning Goal: 1
    Topic: Motives for Mergers

24. A _________ occurs when the operations of the acquiring and target firms are combined in order to achieve economies and thereby cause the performance of the merged firm to exceed that of the pre-merged firm.
    (a) financial merger
    (b) hostile takeover
    (c) operating merger
    (d) strategic merger

    Answer: D
    Level of Difficulty: 3
    Learning Goal: 1
    Topic: Strategic Mergers

25. A friendly merger transaction is typically consummated through all of the following EXCEPT
    (a) a cash purchase.
    (b) an exchange of the acquirer's stock.
    (c) a tender offer.
    (d) an exchange of the acquirer's stock and bonds.

    Answer: C
    Level of Difficulty: 3
    Learning Goal: 1
    Topic: Friendly Mergers

26. A hostile merger is typically accomplished through
    (a) a cash purchase.
    (b) an exchange of the acquirer's stock.
    (c) a tender offer.
    (d) an exchange of the acquirer's stocks and bonds.

    Answer: C
    Level of Difficulty: 3
    Learning Goal: 1
    Topic: Hostile Mergers

27. A(n) _________ is undertaken with the goal of restructuring the acquired company in order to improve its cash flow and unlock its hidden value.
    (a) operating merger.
    (b) strategic merger.
    (c) financial merger.
    (d) hostile takeover.

    Answer: C
    Level of Difficulty: 3
    Learning Goal: 1
    Topic: Financial Mergers

28. A major impetus fueling financial mergers during the 1980s was
    (a) high interest rates.
    (b) high tax rates.
    (c) high cash balances that could be utilized for takeovers.
    (d) ready availability of junk bond financing.

    Answer: D
    Level of Difficulty: 3
    Learning Goal: 1
    Topic: Financial Mergers

29. A merger of a paper manufacturer and a logging company is an example of
    (a) congeneric merger.
    (b) conglomerate merger.
    (c) horizontal merger.
    (d) vertical merger.

    Answer: D
    Level of Difficulty: 3
    Learning Goal: 1
    Topic: Vertical Mergers

30. The reduction of risk resulting from combining firms with differing seasonal or cyclical patterns of sales or earnings is a key benefit of
    (a) congeneric merger.
    (b) conglomerate merger.
    (c) horizontal merger.
    (d) vertical merger.

    Answer: B
    Level of Difficulty: 3
    Learning Goal: 1
    Topic: Conglomerate Mergers

31. A financial merger is undertaken to increase
    (a) operating efficiency, which is used to increase cash flows.
    (b) cash flows, which are used to increase dividends to shareholders.
    (c) market share, which is used to maximize shareholder wealth.
    (d) cash flows, which are used to service the debt typically incurred to finance the merger transaction.

    Answer: D
    Level of Difficulty: 4
    Learning Goal: 1
    Topic: Financial Mergers

32. An attempt to gain control of the firm by buying sufficient shares of the target firm in the marketplace is known as a _________ and is typically accomplished through a _________.
    (a) friendly takeover; tender offer
    (b) hostile takeover; merger
    (c) friendly takeover; merger
    (d) hostile takeover; tender offer

    Answer: D
    Level of Difficulty: 4
    Learning Goal: 1
    Topic: Tender Offers and Hostile Takeovers

33. A merger involving the purchase of a specific product line, rather than the whole company is
    (a) an operating merger.
    (b) a financial merger.
    (c) a selective lines merger.
    (d) a variation of the strategic merger.

    Answer: D
    Level of Difficulty: 4
    Learning Goal: 1
    Topic: Strategic Mergers

34. The use of a large amount of debt to finance the acquisition of other firms is a
    (a) conglomerate merger.
    (b) leveraged buyout.
    (c) hostile merger.
    (d) congeneric buyout.

    Answer: B
    Level of Difficulty: 1
    Learning Goal: 2
    Topic: Leveraged Buyouts

35. The acquisition of a "cash-rich" company allows the acquiring company
    (a) to reap greater tax benefits.
    (b) to reduce leverage and to increase borrowing power.
    (c) to develop better managers.
    (d) to achieve economies of scale in some phase of the business.

    Answer: B
    Level of Difficulty: 1
    Learning Goal: 2
    Topic: Motives for Acquisitions

36. The sale of a unit of a firm to existing management is often achieved through
    (a) a limited partnership.
    (b) a leveraged buyout.
    (c) an employee stock option.
    (d) a cash exchange.

    Answer: B
    Level of Difficulty: 1
    Learning Goal: 2
    Topic: Leveraged Buyouts

37. The selling of some of a firm's assets is called
    (a) business failure.
    (b) vertical segmentation.
    (c) reverse merger.
    (d) divestiture.

    Answer: D
    Level of Difficulty: 1
    Learning Goal: 2
    Topic: Divestitures

38. A divestiture which results in an operating unit becoming an independent company is a
    (a) sale of a line of business.
    (b) sale of a unit to existing management.
    (c) spin-off of an operating unit.
    (d) leveraged buyout.

    Answer: C
    Level of Difficulty: 2
    Learning Goal: 2
    Topic: Spin-Off Divestitures

39. The goals of divestiture include all of the following EXCEPT
    (a) raising funds.
    (b) focusing operations.
    (c) enhancing profitability.
    (d) expanding operations.

    Answer: D
    Level of Difficulty: 2
    Learning Goal: 2
    Topic: Goals of Divestitures

40. A form of divestiture in which an operating unit becomes an independent company by issuing shares in it on a pro rata basis to the parent company's shareholders is called
(a) leverage buyout.
(b) employee stock option.
(c) spin-off.
(d) merger.

Answer: C
Level of Difficulty: 2
Learning Goal: 2
Topic: Spin-Off Divestitures

41. A spin-off results in the divested unit
(a) being sold to existing management resulting in new owners.
(b) becoming an independent company with new owners.
(c) becoming an independent company with the same owners as the parent company.
(d) being managed independently, but still under the ownership of the parent company.

Answer: C
Level of Difficulty: 3
Learning Goal: 2
Topic: Spin-Off Divestitures

42. The result of spin-off to the parent company is
(a) additional stock to the parent.
(b) additional cash from the sale.
(c) additional debt by the parent.
(d) no additional cash or stock to the parent.

Answer: D
Level of Difficulty: 3
Learning Goal: 2
Topic: Spin-Off Divestitures

43. A _________ is a method of structuring a financial merger, whereas a _________ involves the sale of the firm's assets.
(a) leveraged buyout; bankruptcy
(b) congeneric buyout; divestiture
(c) horizontal merger; leveraged divestiture
(d) leveraged buyout; divestiture

Answer: D
Level of Difficulty: 3
Learning Goal: 2
Topic: Leveraged Buyouts

44. Leveraged buyouts are clear examples of
    (a) strategic mergers.
    (b) vertical mergers.
    (c) financial mergers.
    (d) congeneric mergers.

    Answer: C
    Level of Difficulty: 3
    Learning Goal: 2
    Topic: Leveraged Buyouts

45. The creation of a high-debt, private corporation with improved cash flow and value is the goal in
    (a) issuing junk bonds.
    (b) a financial merger.
    (c) a conglomerate merger.
    (d) a leveraged buyout.

    Answer: D
    Level of Difficulty: 3
    Learning Goal: 2
    Topic: Leveraged Buyouts

46. Typically in a leveraged buyout approximately _________ percent (if not more) of the purchase price is financed with debt.
    (a) 30
    (b) 50
    (c) 70
    (d) 90

    Answer: D
    Level of Difficulty: 3
    Learning Goal: 2
    Topic: Leveraged Buyouts

47. An attractive candidate for acquisition through a leveraged buyout should possess all of the following characteristics EXCEPT
    (a) a solid profit history and reasonable expectations for growth.
    (b) low fixed assets.
    (c) a low level of debt.
    (d) stable and predictable cash flows.

    Answer: B
    Level of Difficulty: 3
    Learning Goal: 2
    Topic: Leveraged Buyouts

48. A leveraged buyout needs to be carried out through
    (a) a hostile takeover.
    (b) a friendly merger.
    (c) a vertical merger.
    (d) a conglomerate merger.

    Answer: B
    Level of Difficulty: 3
    Learning Goal: 2
    Topic: Leveraged Buyouts

49. The motive for divestiture is likely to be all of the following EXCEPT
    (a) to generate cash for expansion of other product lines.
    (b) to get rid of poorly performing operations.
    (c) to head off bankruptcy.
    (d) to streamline the corporation.

    Answer: C
    Level of Difficulty: 3
    Learning Goal: 2
    Topic: Motives for Divestitures

50. An attractive candidate for acquisition through leveraged buyout should possess which of the following characteristics?
    (a) A good position in its industry with a solid profit history and reasonable expectations of growth.
    (b) A relatively low level of debt.
    (c) A relatively high level of "bankable" assets that can be used as loan collateral.
    (d) Stable and predictable cash flows that are adequate to meet interest and principal payments on the debt and provide adequate working capital.
    (e) All of the above.

    Answer: E
    Level of Difficulty: 4
    Learning Goal: 2
    Topic: Leveraged Buyouts

51. Cash acquisitions of going concerns are best analyzed using
    (a) an investment opportunity schedule.
    (b) ratio analysis.
    (c) capital budgeting techniques.
    (d) the weighted marginal cost of capital theory.

    Answer: C
    Level of Difficulty: 1
    Learning Goal: 3
    Topic: Acquisition Analysis

52. Normally, the acquiring firm pays a price that is a premium above the market price of the acquired firm. This means that the ratio of exchange in market price is
    (a) always less than 1.
    (b) always greater than 1.
    (c) usually negative.
    (d) equal to 1.

    Answer: B
    Level of Difficulty: 2
    Learning Goal: 3
    Topic: Acquisition Analysis and the Ratio of Exchange

53. Marketing Concepts, Inc. is considering the acquisition of Management Theories, Inc. at a cash price of $1.5 million. Management Theories, Inc. has short-term liabilities of $500,000. As a result of acquiring Management Theories, Inc., Marketing Concepts, Inc. would acquire the copyrights to a national best-seller which would provide an estimated cash flow of $300,000 for the next five years. The firm has a cost of capital of 20 percent. The approximate net present value of this acquisition is
    (a) $500,000.
    (b) $480,800.
    (c) –$102,700.
    (d) –$1,102,700.

    Answer: D
    Level of Difficulty: 3
    Learning Goal: 3
    Topic: Acquisition Analysis

54. The actual ratio of exchange in a stock-exchange acquisition is the ratio of the
    (a) amount paid per share of the target company to the per share book value of the acquiring firm.
    (b) book value per share of the target company to the per share market price of the acquiring firm.
    (c) market value per share of the target company to the per share market price of the acquiring firm.
    (d) amount paid per share of the target company to the per share market price of the acquiring firm.

    Answer: D
    Level of Difficulty: 3
    Learning Goal: 3
    Topic: Acquisition Analysis and the Ratio of Exchange

55. When the ratio of exchange in a merger is equal to one and both the acquiring and the target companies have the same premerger earnings per share, the merged firm's earnings per share will initially
(a) decline.
(b) remain constant.
(c) increase.
(d) drop to zero.

Answer: B
Level of Difficulty: 3
Learning Goal: 3
Topic: Acquisition Analysis and the Ratio of Exchange

56. When the ratio of exchange in a merger is equal to one and both the acquiring and the target companies have the same premerger earnings per share, both the acquiring and the target companies have the same
(a) debt ratio.
(b) book value per share.
(c) return on equity.
(d) P/E ratio.

Answer: D
Level of Difficulty: 3
Learning Goal: 3
Topic: Acquisition Analysis and the Ratio of Exchange

57. If the P/E paid is greater than the P/E of the acquiring company, the effect on the earnings per share of the acquired company will be
(a) positive.
(b) neutral.
(c) negative.
(d) uncorrelated.

Answer: A
Level of Difficulty: 3
Learning Goal: 3
Topic: Acquisition Analysis and the P/E Ratio

58. If the P/E paid is equal to the P/E of the acquiring company, the effect on the earnings per share of the acquired company will be
(a) positive.
(b) neutral.
(c) negative.
(d) uncorrelated.

Answer: B
Level of Difficulty: 3
Learning Goal: 3
Topic: Acquisition Analysis and the P/E Ratio

59. If the P/E paid is less than the P/E of the acquiring company, the effect on the earnings per share of the acquired company will be
    (a) positive.
    (b) neutral.
    (c) negative.
    (d) uncorrelated.

    Answer: C
    Level of Difficulty: 3
    Learning Goal: 3
    Topic: Acquisition Analysis and the P/E Ratio

60. The overriding goal for merging is to
    (a) increase cash flows.
    (b) maximize shareholder wealth as reflected in the acquirer's share price.
    (c) maximize shareholder wealth as reflected in the share price of the target firm.
    (d) maximize operating efficiency.

    Answer: B
    Level of Difficulty: 3
    Learning Goal: 3
    Topic: Motives for Merging

61. When making a cash acquisition of a going concern, the acquiring corporation must be certain
    (a) to adjust after-tax cash flows.
    (b) to recognize different accounting techniques.
    (c) to adjust the discount rate for risk differences.
    (d) to consider the problems of assimilating the acquired management.

    Answer: C
    Level of Difficulty: 3
    Learning Goal: 3
    Topic: Acquisition Analysis

62. The long-run effect on the earnings per share of the merged firm depends largely on
    (a) the pre-merger P/E ratio.
    (b) the ratio of exchange.
    (c) the synergy of the merged firm.
    (d) the tax considerations.

    Answer: C
    Level of Difficulty: 3
    Learning Goal: 3
    Topic: Motivation for Merging

63. Firmatron, Inc. is evaluating the acquisition of Health-o-Matic, Inc., which had a loss carryforward of $3.75 million, resulting from earlier operations. Firmatron can purchase Health-o-Matic for $4.5 million and liquidate the assets for $3.25 million. Firmatron expects earnings before taxes in the three years following the acquisition to be as follows:

Year	Earnings before Taxes
1	$1,270,000
2	1,662,400
3	1,275,000

(These earnings are assumed to fall within the annual limit legally allowed for application of a tax loss carryforward resulting from the proposed acquisition.) Firmatron has a 40 percent tax rate and a cost of capital of 15 percent. The approximate maximum cash price Firmatron would be willing to pay for Health-o-Matic is

(a) $4,750,000.
(b) $4,500,000.
(c) $4,410,000.
(d) $3,750,000.

Answer: C
Level of Difficulty: 4
Learning Goal: 3
Topic: Acquisition Analysis and Tax Loss Carryforward

64. Maxi, Inc. is evaluating the acquisition of Mini, Inc., which had a loss carryforward of $2.75 million which resulted from earlier operations. Maxi can purchase Mini for $3.5 million and liquidate the assets for $1.25 million. Maxi expects earnings before taxes in the three years following the acquisition to be as follows:

Year	Earnings before Taxes
1	$800,000
2	850,000
3	900,000

(These earnings are assumed to fall within the limit legally allowed for application of a tax loss carryforward resulting from the proposed acquisition.) Maxi has a 40 percent tax rate and a cost of capital of 10 percent. The total present value of tax advantage of the acquisition in the following three years is

(a) $440,000.
(b) $842,000.
(c) $1.1 million.
(d) $2.75 million.

Answer: B
Level of Difficulty: 4
Learning Goal: 3
Topic: Acquisition Analysis and Tax Loss Carryforward

65. A formal proposal to purchase a given number of shares of a firm's stock at a specified price is a
    (a) warrant.
    (b) stock purchase option.
    (c) right.
    (d) tender offer.

    Answer: D
    Level of Difficulty: 1
    Learning Goal: 4
    Topic: Tender Offers

66. The "stakeholders" in targeted takeover companies include the
    (a) customers.
    (b) creditors.
    (c) employees.
    (d) stockholders.
    (e) all of the above.

    Answer: E
    Level of Difficulty: 1
    Learning Goal: 4
    Topic: Stakeholders

67. The primary advantage of a holding company, that permit(s) the firm to control a large amount of assets with a relatively small dollar investment is known as
    (a) the leverage effect.
    (b) tax effects.
    (c) administrative costs.
    (d) risk protection.

    Answer: A
    Level of Difficulty: 1
    Learning Goal: 4
    Topic: Advantages of Holding Companies

68. All of the following are disadvantages of holding companies EXCEPT
    (a) increased risk.
    (b) double taxation.
    (c) high cost of administration.
    (d) legal responsibility for subsidiaries.

    Answer: D
    Level of Difficulty: 1
    Learning Goal: 4
    Topic: Disadvantages of Holding Companies

69. Most firms seeking merger partners will hire the services of
    (a) a commercial banker.
    (b) an investment broker.
    (c) a private contractor.
    (d) an investment banker.

    Answer: D
    Level of Difficulty: 1
    Learning Goal: 4
    Topic: Investment Bankers Role in Mergers

70. All of the following may be true about tender offers EXCEPT
    (a) they may add pressure to existing merger negotiations.
    (b) management has the exclusive right to accept the offer.
    (c) defensive tactics may be taken to ward off the offer.
    (d) they may be made without warning as an abrupt attempt at a corporate takeover.

    Answer: B
    Level of Difficulty: 3
    Learning Goal: 4
    Topic: Tender Offers

71. In defending against a hostile takeover, the strategy that involves the target firm finding a more suitable acquirer and prompting it to compete with the initial hostile acquirer to take over the firm is called the _________ strategy.
    (a) poison pill
    (b) white knight
    (c) golden parachute
    (d) greenmail

    Answer: B
    Level of Difficulty: 3
    Learning Goal: 4
    Topic: Hostile Takeover Defense Strategies

72. In defending against a hostile takeover, the strategy that involves the target firm creating securities that give their holders certain rights that become effective when a takeover is attempted is called the _________ strategy.
    (a) shark repellent
    (b) greenmail
    (c) poison pill
    (d) golden parachute

    Answer: C
    Level of Difficulty: 3
    Learning Goal: 4
    Topic: Hostile Takeover Defense Strategies

73. In defending against a hostile takeover, the strategy that involves the firm repurchasing through negotiation a large block of stock at a premium from one or more shareholders in order to end those shareholders' hostile takeover attempt is known as the _________ strategy.

(a) poison pill
(b) greenmail
(c) golden parachute
(d) shark repellent

Answer: B
Level of Difficulty: 3
Learning Goal: 4
Topic: Hostile Takeover Defense Strategies

74. In defending against a hostile takeover, the strategy involving the payment of a large, debt-financed, cash dividend is the _________ strategy.

(a) shark repellent
(b) golden parachute
(c) leveraged recapitalization
(d) white knight

Answer: C
Level of Difficulty: 3
Learning Goal: 4
Topic: Hostile Takeover Defense Strategies

75. In defending against hostile takeover attempts, a company will include provisions in the employment contracts of key executives that provide them with sizable compensation if the firm is taken over. This is called the _________ strategy.

(a) shark repellent
(b) white knight
(c) greenmail
(d) golden parachute

Answer: D
Level of Difficulty: 3
Learning Goal: 4
Topic: Hostile Takeover Defense Strategies

76. In defending against hostile takeover attempts, a company will approve anti-takeover amendments to the corporate charter that constrain the firm's ability to transfer managerial control of the firm as a result of a merger. This is called the _________ strategy.

(a) golden parachute
(b) greenmail
(c) poison pill
(d) shark repellent

Answer: D
Level of Difficulty: 3
Learning Goal: 4
Topic: Hostile Takeover Defense Strategies

77. A key consideration in the holding company decision is
(a) the risk-return tradeoff due to the leverage effect.
(b) the greater “distance” between top level and operating management.
(c) the risk of the domino effect if one company in the holding company fails.
(d) the risk from the separate “companies” in the holding company being classed as one company.

Answer: A
Level of Difficulty: 3
Learning Goal: 4
Topic: Advantages of Holding Companies

78. All of the following are advantages of holding companies EXCEPT
(a) possible state tax benefits realized by each subsidiary in its state of incorporation.
(b) since each subsidiary is a separate corporation, the failure of one company should cost the holding company no more than its investment in that subsidiary.
(c) reduced federal corporate taxes due to the holding company status.
(d) lawsuits or legal actions against a subsidiary will not threaten the remaining companies.

Answer: C
Level of Difficulty: 3
Learning Goal: 4
Topic: Advantages of Holding Companies

79. Business failure may be caused by all of the following EXCEPT
(a) low or negative returns.
(b) technical insolvency.
(c) book value of assets that exceed liabilities.
(d) liabilities that exceed market value of assets.

Answer: C
Level of Difficulty: 1
Learning Goal: 5
Topic: Causes of Business Failure

80. Business failure may be caused by all of the following EXCEPT
(a) corporate maturity.
(b) mismanagement.
(c) economic downturns.
(d) increasing liquidity.

Answer: D
Level of Difficulty: 1
Learning Goal: 5
Topic: Causes of Business Failure

81. _________ is an arrangement initiated by the debtor firm to negotiate with the creditors about a plan for sustaining or liquidating the firm.
    (a) An involuntary reorganization
    (b) An involuntary liquidation
    (c) A filing of Chapter Seven of the Bankruptcy Reform Act of 1978
    (d) A voluntary settlement

    Answer: D
    Level of Difficulty: 1
    Learning Goal: 5
    Topic: Voluntary Settlements

82. _________ is an arrangement whereby the firm's creditors receive full payment, although not immediately.
    (a) A composition
    (b) A creditor control agreement
    (c) An extension
    (d) A liquidation

    Answer: C
    Level of Difficulty: 1
    Learning Goal: 5
    Topic: Extensions in Voluntary Settlements

83. _________ is a pro rata cash settlement of creditor claims.
    (a) A composition
    (b) A creditor control agreement
    (c) An extension
    (d) A liquidation

    Answer: A
    Level of Difficulty: 1
    Learning Goal: 5
    Topic: Compositions in Voluntary Settlements

84. _________ may replace the operating management with a selected creditor.
    (a) A composition
    (b) A creditor control agreement
    (c) An extension
    (d) A liquidation

    Answer: B
    Level of Difficulty: 1
    Learning Goal: 5
    Topic: Creditor Control Agreements in Voluntary Settlements

85. In a voluntary settlement, each creditor will be paid 20 cents on the dollar in 120 days. The remaining 80 cents on the dollar will be paid within an additional 60 days. This is an example of
(a) a composition.
(b) a combination of a composition and extension.
(c) an extension.
(d) a liquidation.

Answer: C
Level of Difficulty: 3
Learning Goal: 5
Topic: Extensions in Voluntary Settlements

86. In a voluntary settlement, each creditor will be paid only 45 cents on the dollar immediately. This is an example of
(a) a composition.
(b) a combination of a composition and extension.
(c) an extension.
(d) a liquidation.

Answer: A
Level of Difficulty: 1
Learning Goal: 5
Topic: Compositions in Voluntary Settlements

87. In a voluntary settlement, one group of creditors having claims of $1,000,000 will be immediately paid 95 cents on the dollar. The remainder of the creditors will postpone payment an additional 60 days. This is an example of
(a) a composition.
(b) a combination of a composition and extension.
(c) an extension.
(d) a liquidation.

Answer: B
Level of Difficulty: 3
Learning Goal: 5
Topic: Compositions and Extensions in Voluntary Settlements

88. In _________, an assignment may be made by the creditors to a third party who then has the power to liquidate the firm's assets.
(a) a voluntary private liquidation
(b) an involuntary private liquidation
(c) an involuntary liquidation under Chapter Seven of the Bankruptcy Reform Act of 1978
(d) a voluntary liquidation under Chapter Seven of the Bankruptcy Reform Act of 1978

Answer: A
Level of Difficulty: 3
Learning Goal: 5
Topic: Voluntary Private Liquidations

89. A reorganization plan must meet all of the following criteria EXCEPT
    (a) it must be fair and equitable.
    (b) it must be feasible.
    (c) it maintains the priorities of the contractual claims of all parties.
    (d) the market value of the firm's assets must exceed the stated liabilities.

    Answer: D
    Level of Difficulty: 2
    Learning Goal: 6
    Topic: Reorganization Plans

90. An involuntary petition for reorganization may be filed against a firm if any one of the following conditions are met EXCEPT
    (a) the book value of the firm's assets is less than the stated liabilities.
    (b) past-due debts of $5,000 or more.
    (c) three or more creditors who can prove aggregate claims of $5,000 against the firm.
    (d) insolvency.

    Answer: A
    Level of Difficulty: 3
    Learning Goal: 6
    Topic: Involuntary Reorganization in Chapter 11 Bankruptcy

91. The responsibilities of the debtor in possession include all of the following EXCEPT
    (a) the valuation of the firm as a going concern.
    (b) drawing up a plan of reorganization.
    (c) recommending a recapitalization plan.
    (d) liquidating the assets of the firm.

    Answer: D
    Level of Difficulty: 3
    Learning Goal: 6
    Topic: Debtor in Possession in Chapter 11 Bankruptcy

92. An important aspect of the firm's reorganization plan is the recapitalization of the firm's capital structure. The goal of restructuring the firm's debt includes all of the following EXCEPT
    (a) providing a reasonable level of earnings for the owners.
    (b) exchanging debt for equity.
    (c) reducing the fixed-payment obligations.
    (d) decreasing the times interest earned ratio.

    Answer: D
    Level of Difficulty: 3
    Learning Goal: 6
    Topic: Recapitalization in Chapter 11 Bankruptcy

93. The priority of claims established by Chapter Seven of the Bankruptcy Reform Act of 1978 gives priority to
(a) unpaid employee benefit plan contributions over unsecured customer deposits.
(b) common stockholders over taxes.
(c) taxes over expenses of administering the bankruptcy.
(d) preferred stockholders over claims of secured creditors.

Answer: A
Level of Difficulty: 3
Learning Goal: 6
Topic: Priority of Claims in Chapter 7 Bankruptcy

94. The priority of claims established by Chapter Seven of the Bankruptcy Reform Act of 1978 gives priority to claims of
(a) unsecured creditors over claims of secured creditors.
(b) preferred stockholders over claims of unsecured creditors.
(c) wages payable over claims of unsecured creditors.
(d) farmers in grain storage over expenses of administering the bankruptcy.

Answer: C
Level of Difficulty: 3
Learning Goal: 6
Topic: Priority of Claims in Chapter 7 Bankruptcy

95. White and Wong, Inc. recently has had financial difficulty and is being liquidated by the Federal Bankruptcy Court. The firm has a liquidation value of $1,000,000—$400,000 from the fixed assets that served as collateral for the mortgage bonds and $600,000 from all other assets (all prior claims have been satisfied). The firm's current capital structure is as follows:

Source of Capital	**Amount**
Unsecured bonds	$500,000
Mortgage bonds	400,000
Preferred stock	100,000
Common stock	500,000

The common stockholders will receive _________ in the liquidation.
(a) $500,000
(b) $333,333
(c) $198,000
(d) $0

Answer: D
Level of Difficulty: 4
Learning Goal: 6
Topic: Chapter 7 Bankruptcy Analysis

96. Tangshan Mining is considering the acquisition of Zhengsen Mining at a cash price of $6,000,000. The primary motivation for Tangshan's purchase of Zhengsen is for a special piece of drilling equipment that it believes will generate after-tax cash flows if $2,000,000 per year during the next 5 years. Zhengsen Mining has liabilities of $9,000,000 and Tangshan estimates that it can sell the remaining assets $6,500,000. Tangshan will use a 15 percent cost of capital for evaluating the acquisition. Based on this information, what is the net value of the special drilling equipment?
   (a) $1,795,690
   (b) $1,500,000
   (c) ($1,795,690)
   (d) ($1,500,000)

   Answer: C
   Level of Difficulty: 3
   Learning Goal: 3
   Topic: Acquisition Analysis

97. Tangshan Mining is considering the acquisition of Zhengsen Mining at a cash price of $6,000,000. The primary motivation for Tangshan's purchase of Zhengsen is for a special piece of drilling equipment that it believes will generate after-tax cash flows of $2,000,000 per year during the next 5 years. Zhengsen Mining has liabilities of $9,000,000 and Tangshan estimates that it can sell the remaining assets $6,500,000. Tangshan will use a 15 percent cost of capital for evaluating the acquisition. Based on this information, what is the net value of the special drilling equipment? Calculate the net value of a second alternative that would allow Tangshan to purchase a better quality asset for $12,000,000 that would provide a $2,600,000 in after-tax inflows for the next 5 years. Which alternative would you choose?
   (a) $1,795,690, $3,284,396, both
   (b) $1,500,000, $4,500,000, both
   (c) ($1,795,690), ($3,284,396), neither
   (d) ($1,795,690), ($4,500,000), neither

   Answer: C
   Level of Difficulty: 4
   Learning Goal: 3
   Topic: Acquisition Analysis

98. Tangshan Mining is attempting to acquire Zhengsen Mining. Selected financial data is presented for both companies in the table below:

Item	Tangshan Mining	Zhengsen Mining
Earnings available for common stock	$100,000	$40,000
Number of shares of stock outstanding	100,000	20,000
Market price per share	$60	$120

Tangshan Mining has sufficient authorized but unissued shares to carry out the proposed merger. If the ratio of exchange is 1.8, what will be the EPS of the merged firm?

(a) $1.00
(b) $1.029
(c) $1.078
(d) $2.00

Answer: B
Level of Difficulty: 4
Learning Goal: 3
Topic: Ratio of Exchange and EPS

99. Key advantages of holding companies include all of the following EXCEPT

(a) they permit a firm to control a large amount of assets with relatively small dollar investment.
(b) they help in terms of risk protection because the failure of one of the companies does not result in the failure of the entire firm.
(c) lawsuits or legal actions against a subsidiary do not threaten the remaining companies.
(d) All of the above are advantages.

Answer: D
Level of Difficulty: 2
Learning Goal: 4
Topic: Advantages of Holding Companies

100. Key disadvantages of holding companies include all of the following EXCEPT

(a) they result in increased risk because of the leverage effect.
(b) they result in triple taxation.
(c) they are difficult to analyze.
(d) they are costly to administer.

Answer: B
Level of Difficulty: 2
Learning Goal: 4
Topic: Disadvantages of Holding Companies

■ Essay Questions

1. Baker's Oven Manufacturing is evaluating the acquisition of Cuisinaire Kitchen Appliance Co. Cuisinaire has a loss carryforward of $1.5 million which resulted from earlier operations. Baker's Oven can purchase Cuisinaire for $1.8 million and liquidate the assets for $1.3 million. Baker's Oven expects earnings before taxes in the five years following the acquisition to be as follows:

Year	Earnings before Taxes
1	$108,000
2	288,000
3	324,000
4	425,000
5	425,000

(These earnings are assumed to fall within the annual limit legally allowed for application of the tax loss carryforward resulting from the proposed acquisition.) Baker's Oven is in the 40 percent tax bracket and has a cost of capital of 17 percent.

(a) What is the tax advantage of the acquisition each year for Baker's Oven?

(b) What is the maximum cash price Baker's Oven would be willing to pay for Cuisinaire?

(c) Do you recommend the acquisition? Why or why not?

Answers:

Year	Earnings before Taxes	Taxes	Tax Relief
1	$0	0	$43,200
2	0	0	115,200
3	0	0	129,600
4	0	0	170,000
5	70,000	28,000	142,000

Total tax relief = $1,500,000 × 0.40 = $600,000

(b)

Year	Tax Benefit		PVIF, 17%, n		
1	$43,200	×	0.855	=	$36,936
2	115,200	×	0.731	=	84,211
3	129,600	×	0.624	=	80,870
4	170,000	×	0.534	=	90,780
5	142,000	×	0.456	=	64,752
Total PV of tax benefits					$357,549

Liquidation value of assets	$1,300,000
+ PV of tax benefits	357,549
Maximum Price	$1,657,549

(c) No, the PV of the benefits is less than the purchase price of the acquisition ($1.8 million).

Level of Difficulty: 3
Learning Goal: 3
Topic: Acquisition Analysis and Tax Loss Carryforward

2. General Electronics, Inc. is considering the acquisition of Datamatic, Inc. at a cash price of $5,000,000. Datamatic, Inc. has short-term liabilities of $1,500,000. As a result of acquiring Datamatic, Inc., General Electronics would also acquire rights to one major patent which would provide an estimated cash inflow of $1,800,000 per year for the next eight years. The firm has a cost of capital of 12 percent. Would you recommend the cash acquisition?

Answer:

	PVIF, 12%, n	**PV of CF**
CFO ($5,000,000)		($5,000,000)
CF1 ($1,500,000)* + $1,800,000	0.893	267,900
CF2–8 $1,800,000	(4.968 – 0.893)	7,335,000
		NPV $2,602,900

*Assumed short-term liabilities were paid off in first year since the NPV > 0, the General Electronics should acquire Datamatic, Inc.

Level of Difficulty: 3
Learning Goal: 3
Topic: Acquisition Analysis

3. Holiday Tanning Systems has an estimated liquidation value (after all prior claims have been satisfied) of $3,000,000; $1,500,000 from fixed assets and $1,500,000 from current assets. The firm's value as a going concern is $4,000,000. The firm's current capital structure is as follows:

Debentures	$ 5,000,000
Mortgage bonds*	2,000,000
Preferred stock	1,000,000
Common stock	4,000,000
Total	$12,000,000

*Secured by fixed assets.

Prepare a table indicating the amount, if any, to be distributed to each claimant, in the event of liquidation.

Answer:

Source of Capital	**Claim**
Debentures 5 ÷ 5.5 ($1,500,000)	= $1,363,636
Mortgage bonds 0.5 ÷ 5.5 ($1,500,000) + $1,500,000**	= 1,636,364
Preferred stock	= 0
Common stock	= 0

After payment to the mortgage bondholders from the $1,500,000 proceeds from the sale of the fixed assets, the remaining debt is ($7,000,000 – 1,500,000 =) $5,500,000.

**Mortgage bond receives $1,500,000 from fixed assets liquidation and then joins liquidation as a general creditor.

Level of Difficulty: 4
Learning Goal: 5
Topic: Chapter 7 Bankruptcy Analysis

4. A firm's current structure is as follows:

Debentures	$5,000,000
Mortgage bonds*	2,000,000
Preferred stock	1,000,000
Common stock	4,000,000
Total	$12,000,000

* Secured by fixed assets.

Suggest a recapitalized capital structure that would reduce the debt/equity ratio (several solutions are feasible). Calculate the d/e ratio for the pre-reorganization capital structure and the post-reorganization capital structure.

Answer: A suggested recapitalization plan:

Debentures	5,000,000	Debentures	1,500,000
Mortgage bonds	2,000,000	Mortgage bonds	500,000
Preferred stock	1,000,000	Income bonds	500,000
Common stock	4,000,000	Preferred stock	500,000
		Common stock	1,000,000
	12,000,000		4,000,000
	D/E = 1.40		D/E = 1.00*

*Income bonds, preferred stock and common stock are included in stockholders' equity.

Level of Difficulty: 4
Learning Goal: 6
Topic: Chapter 11 Bankruptcy Analysis and Recapitalization

5. Tangshan Mining is attempting to acquire Zhengsen Mining. Selected financial data is presented for both companies in the table below:

Item	Tangshan Mining	Zhengsen Mining
Earnings available for common stock	$10,000,000	$1,000,000
Number of shares of stock outstanding	1,000,000	50,000
Market price per share	$100	$120

Tangshan Mining has sufficient authorized but unissued shares to carry out the proposed merger.

(a) Calculate the EPS of Tangshan Mining and Zhengsen Mining before the merger.

(b) If the ratio of exchange is 1.8, what will be the earnings per share of the merged company?

(c) Repeat part (a) if the ratio of exchange is 2.0.

(d) Repeat part (a) if the ratio of exchange is 2.2

(e) discuss the principal illustrated by your answers to parts (a) through (d)

Answers:

(a) Prior to the merger, the EPS of Tangshan is $10.00 and the EPS of Zhengsen is $20.

(b) If the ratio of exchange is 1.8, then Tangshan will give Zhengsen 1.8 of its shares for Zhengsen's 50,000 shares or 90,000 shares. The combined earnings of the two companies are $11,000,000. The total number of shares of Tangshan will now be 1,090,000. Therefore, EPS for the combined company will be $11,000,000 ÷ 1,090,000 = $10.09.

(c) If the ratio of exchange is 2.0, then Tangshan will give Zhengsen 2.0 of its shares for Zhengsen's 50,000 shares or 1,090,000 shares. The combined earnings of the two companies are $11,000,000. The total number of shares of Tangshan will now be 1,100,000. Therefore, EPS for the combined company will be $11,000,000 ÷ 1,100,000 = $10.00. This is the same value for Tangshan as before the merger.

(d) If the ratio of exchange is 2.2, then Tangshan will give Zhengsen 2.2 of its shares for Zhengsen's 50,000 shares or 110,000 shares. The combined earnings of the two companies are $11,000,000. The total number of shares of Tangshan will now be 1,110,000. Therefore, EPS for the combined company will be $11,000,000 ÷ 1,110,000 = $9.91.

(e) This shows that the greater the ratio of exchange, the lower will be the EPS of the combined firm after the merger.

Level of Difficulty: 4
Learning Goal: 3
Topic: Ratio of Exchange and EPS